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FOREIGN SALES CORPORATION ACT

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1804

NOVEMBER 18, 1983

Part 1 of 2

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FOREIGN SALES CORPORATION ACT

FRIDAY, NOVEMBER 18, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. John C. Danforth presiding.

Present: Senator Danforth.

Also present: Congressman de Lugo.

[The press release announcing the hearing and a description of S. 1804 by the Joint Committee on Taxation follow:]

[Press Release No. 83-199]

FINANCE COMMITTEE ANNOUNCES HEARING ON FOREIGN SALES CORPORATION ACT

Senator Robert J. Dole (R., Kans.), chairman of the Committee on Finance, announced today that a hearing will be held on Friday, November 18, 1983, on S. 1804, the Foreign Sales Corporation Act of 1983.

The hearing will begin at 9:30 a.m. in room SD-215 of the Dirksen Senate Office Building.

S. 1804, introduced by Senator Dole for himself with Senators Boren and Symms on August 4, 1983, would provide new tax rules for exports of goods and services. The legislation would implement the Administration's proposal to repeal the present Domestic International Sales Corporation [DISC] rules, with an exception for small exporters. Under the proposal, DISC's would be replaced by the Foreign Sales Corporations, a new kind of entity which must be organized outside the United States' jurisdiction and meet other requirements in order to obtain a partial tax exemption.

Senator Dole stated that "the Committee will be reviewing S. 1804 in light of the Administration's desire to replace DISC with GATT-compatible tax rules which do not diminish the competitive posture of American exporters." Senator Dole invited interested witnesses to submit testimony on the broader issues of GATT compatibility, as well as the specifics of S. 1804.

REPLACEMENT OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs)

DESCRIPTION OF S. 1804 (FOREIGN SALES CORPORATION ACT)

Scheduled for a Hearing

before the

COMMITTEE ON FINANCE

ON NOVEMBER 18, 1983

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on S. 1804 (Foreign Sales Corporation Act of 1983) on November 18, 1983. S. 1804 (introduced by Senators Dole, Boren, and Symms) embodies the Administration's proposed replacement of current tax code provisions relating to Domestic International Sales Corporations (DISCs) with Foreign Sales Corporations (FSCs).

The first part of the pamphlet is a summary. The second part is a discussion of background and present law regarding the DISC tax provisions and the GATT (General Agreement on Tariffs and Trade). The third part is an explanation of the provisions of S. 1804. Part four is an economic analysis of S. 1804. Appendix A provides a side-by-side comparison of the principal provisions of DISC and the proposed FSC; Appendix B contains relevant GATT documents; and Appendix C contains a flow chart illustrating how taxpayers would qualify for the benefits of S. 1804.

I. SUMMARY

Domestic International Sales Corporations (DISCs)

Originally proposed by the U.S. Treasury Department in 1970, a system of export income tax deferral for Domestic International Sales Corporations (DISCs) was enacted by Congress as Title V of the Revenue Act of 1971. The DISC legislation had several purposes. Congress was concerned that many trading nations provided more favorable tax treatment for their exports than the United States provided for U.S. exports, and intended to redress that imbalance in tax treatment. A second purpose was to stimulate exports and thereby improve the nation's balance of payments. A third purpose of DISC was to equalize the tax treatment accorded U.S.-based exporters, on the one hand, and U.S.-owned foreign manufacturing subsidiaries (not subject to current U.S. tax), on the other, and thereby remove an incentive to move manufacturing jobs overseas. It was anticipated that the DISC provisions would particularly aid smaller companies.

A DISC is typically a domestic subsidiary of a U.S. company that is engaged in exporting. The income attributable to qualified export receipts is apportioned between the parent and the DISC, using one of two optional formula pricing rules or, at the choice of the taxpayer, the arm's-length method.

The profits allocated to a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed or deemed distributed. Each year, a DISC is deemed to have distributed a portion of its income, thereby subjecting that income to current taxation in the shareholder's hands. As originally enacted, DISC generally provided for an annual deemed distribution of 50 percent of a DISC's profits. Thus, tax deferral was limited to 50 percent of the DISC's export income.

To qualify as a DISC, at least 95 percent of a corporation's assets must be export-related and at least 95 percent of the corporation's gross income must arise from export sales or lease transactions and other export-related activities. Special intercompany pricing rules apply with respect to transactions between a DISC and related parties. In general, under these pricing rules, a DISC may earn up to 4 percent of gross export receipts or 50 percent of the combined taxable income of the DISC and its supplier.

In the early and mid-1970s, there were legislative proposals to repeal the DISC legislation or to give the President authority to terminate the application of the DISC provisions as part of multilateral trade agreements. After examining the original DISC provisions at great length, Congress substantially amended them in the Tax Reform Act of 1976. The amendments reflected Congressional concern over the revenue cost of DISC and Congressional belief that the DISC program could be made more efficient and less costly while still providing the same incentive for increased exports and jobs. The most significant amendment was the addition of an incremental method for determining the annual deemed distribution. Generally, under this method, the portion of DISC income qualifying for tax deferral was reduced to 50 percent of the DISC income attributable to increased exports over a base-period figure. Small DISCs are exempted from the incremental rule.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress reduced the percentage applied to determine DISC income subject to deferral from 50 percent to 42.5 percent for corporate shareholders. This 42.5 percent deferral generally allows deferral of tax on as much as either (1) 21.25 percent of the combined taxable income of a DISC and its related supplier (under the 50-50 intercompany pricing rule), or (2) 1.7 percent of gross export receipts (under the four-percent intercompany pricing rule). Any application of the incremental rule reduces the amount of this deferral, however.

From its inception, DISC was the object of criticism from foreign countries. Several countries, along with the European Economic Community, alleged that DISC was an export subsidy that violated the General Agreement on Tariffs and Trade (GATT). Without agreeing that DISC violates GATT, the Administration has proposed the repeal of DISC and its replacement with a new entity, the "Foreign Sales Corporation" (contained in S. 1804, summarized below).

S. 1804—Foreign Sales Corporation Act

FSC Provisions

S. 1804, the proposed Foreign Sales Corporation Act, would provide a new set of tax rules for exports of goods and services. The bill would provide for the establishment of foreign sales corporations (FSCs) which would typically be foreign incorporated subsidiaries of U.S. parents engaged in exporting. Under the bill, an exporter using a FSC could use safe-harbor pricing rules that would generally exempt from U.S. income tax the greater of 17 percent of the taxable income that a FSC and a related party derive from an export transaction or up to some 1.35 percent of the gross receipts from the transaction. The bill would repeal the present DISC rules, with an exception for small exporters, and it would forgive tax on DISC income that has already benefited from tax deferral.

A FSC must be organized under the laws of a jurisdiction outside the U.S. customs area. It must have at least one director who is not a U.S. resident. It must maintain an office outside U.S. customs territory, and it must keep tax records both at that office and in the United States. Finally, it must elect FSC treatment.

The tax rules of the bill would apply to the export income of a FSC if it is managed outside the United States and if economic processes of the transaction take place outside the United States. In addition, the bill would apply to the export income of a small FSC attributable to up to $2,500,000 of export receipts whether or not its management or economic processes are foreign.

To be managed outside the United States, an FSC must have its shareholders' meetings, board meetings, and principal bank account outside the United States. To meet the foreign economic process test with respect to a transaction, the FSC or its agent must solicit, negotiate, or make the contract relating to the transaction outside the United States. In addition, half of the costs the FSC incurs for advertising, handling orders, transportation, collection, and assumption of credit risk with respect to a transaction must be for performance outside the United States; alternatively, 85 percent of its costs for any two of these five activities must be for their performance outside the United States.

Some export transactions between FSCs and related U.S. taxpayers would qualify for administrative transfer pricing rules. These administrative pricing rules would be available only if the foreign sales corporation or its agent performs all the activities of the economic process test. Under the administrative pricing rules, the FSC generally would earn the greater of 23 percent of the taxable income that it and its related party derive from the transaction or 1.83 percent of the gross receipts from the transaction.

The bill would exempt a portion of the export income of a foreign sales corporation from U.S. tax. If a transaction is subject to one of the administrative transfer pricing rules, this exempt portion would be 17/23 of FSC's income from the transaction. Less frequently, this exempt portion would be 34 percent of its export income. The rest of export income (including generally 6/23 of the FSC's income) would be subject to U.S. tax. All investment income of a FSC would also be subject to U.S. tax. Dividends from export income of a FSC to a U.S. corporate shareholder would be tax-exempt at the corporate shareholder level.

The bill would provide tax deferral under the present DISC rules for up to $10 million of export receipts for small exporters, but would require those companies to pay interest on the deferred tax.

The bill would require that FSCs and DISCs have the same taxable year as their parent corporations. It would provide that income from trade receivables of a related party would be passive income subject to the anti-incorporated pocketbook and anti-tax haven rules. Also, it would treat accumulated DISC income as having been previously taxed, so that tax on those amounts would be forgiven and all previously deferred income could be distributed tax-free.

Comparison of the Effects of DISC and FSC

Like the DISC legislation, the FSC proposal would lower the effective U.S. tax rate on income from capital used in the production of exports. However, it has been argued that the FSC substitute may be less efficient than DISC since exporters would incur operating expenses (and perhaps foreign taxes) associated with their offshore FSCs. Also, compared to DISC, the FSC substitute favors large, older, and slower growing exporters relative to small, new, and rapidly growing export companies. On the other hand, the FSC substitute does not contain some of the disadvantages of a DISC. For example, under the FSC rules there is no requirement equivalent to the qualified assets test; this results in two important differences between DISC and FSC. First, a company would have no restrictions under the FSC rules on how funds are invested; such flexibility is clearly important to business decisions. Second, the consequences of failure of a DISC to meet the qualified assets test (and the gross receipts test) are severe; all previously deferred income may be triggered. In contrast, no such harsh result with respect to prior years could occur under the FSC proposal. Furthermore, the captive DISC demand for Export-Import Bank obligations would be eliminated, reducing the bank's ability to finance U.S. exports.

II. BACKGROUND AND PRESENT LAW

A. DISC—Legislative History and Present Law

Overview

In the Revenue Act of 1971, Congress provided a system of tax deferral for corporations known as Domestic International Sales Corporations (DISCs) and their shareholders (Code secs. 991–997). The legislation creating DISC mandated annual Treasury Department reports on its operation and effect. The Treasury has issued 10 such reports, the most recent, covering 1981, in July 1983.[1] That report estimates that the DISC legislation increased exports in DISC year 1981 by between $7 billion and $11 billion over what they otherwise would have been. The estimated revenue cost of DISC in that year was $1.65 billion.

Background—U.S. Taxation of Foreign Income

The United States subjects to tax the worldwide income of any corporation organized under the laws of the United States. However, foreign corporations (even those that are subsidiaries of U.S. companies) generally are taxed by the United States only to the extent they earn income from a business in the United States or derive investment income there. As a result, the United States usually does not impose a tax on the foreign source income of a foreign corporation even though it is owned or controlled by U.S. persons. Instead, the foreign source earnings of a foreign corporation generally are subject to U.S. income taxes only when and if they are actually remitted to U.S. shareholders as dividends. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. U.S. tax on the dividend income may be offset by foreign tax credits.

An exception to the general rule is provided for certain "tax haven" base company type activities of controlled foreign corporations (sec. 951). These are foreign corporations more than 50 percent of the stock of which is owned by U.S. shareholders each of which owns at least 10 percent of the corporation's stock. The U.S. shareholders of these corporations are taxed under the subpart F provisions of the Code, enacted in 1962 (and subsequently amended). Under these provisions, certain earnings and profits of the controlled foreign corporation ("subpart F income") are deemed to be distributed to the U.S. shareholders, and are subject to taxation currently whether or not the shareholders actually receive the income in the form of a dividend.

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[1] Department of the Treasury, "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1981 Annual Report," July 1983.

Subpart F income includes foreign base company sales income, which means sales income earned by a foreign subsidiary on the sale of property purchased from, or sold to, a related company if the property was neither manufactured in nor sold for use in the country in which the subsidiary is incorporated.[2] A U.S. manufacturer generally cannot establish a foreign sales subsidiary in a tax haven through which to route export transactions or other sales transactions without incurring U.S. tax on the subsidiary's income. Although the list of categories of subpart F income has grown and changed since 1962 and since enactment of DISC in 1971, the provision that subjects foreign base company sales income to current U.S. tax has remained basically the same.

Legislative History of DISC

1970 Administration proposal

The DISC legislation was first proposed by the U.S. Treasury Department in 1970.[3] The Treasury Department argued that changes were needed in the tax treatment of exported goods in order to encourage exports of U.S. goods and thereby improve the balance of payments.[4] Restriction of imports was considered impractical since it could invite retaliation by U.S. trading partners; also, the Treasury Department suggested that the freedom to import was one of the most effective possible checks on domestic inflationary pressures.

The Treasury Department argued that the existing tax structure tended to create an unnecessary drag on exports and gave some incentive to manufacture abroad rather than in the United States since income from the sale of the foreign manufacturing subsidiary's goods generally is not taxed by the United States until distributed to the shareholders. With the enactment of the anti-tax haven provisions of subpart F in the Revenue Act of 1962, full deferral generally could no longer be obtained by the use of a foreign sales subsidiary to distribute goods manufactured in the United States. In addition, other countries generally appeared to provide more favorable tax treatment for export income than the United States. The DISC legislation was intended to put the domestic manufacturer on a competitive basis with offshore manufacturing subsidiaries (and with foreign-owned manufacturers) by deferring a portion of income from tax until distributed to the shareholders.

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[2] There are now five other categories of subpart F income taxed currently to U.S. shareholders of controlled foreign corporations: (1) income from the insurance of U.S. risks; (2) passive investment income such as dividends, interest, royalties, and rents ("foreign personal holding company income"); (3) income from services performed for or on behalf of a related person by the foreign subsidiary outside of the country in which it is incorporated ("foreign base company services income"); (4) shipping income earned by a foreign subsidiary outside of the country in which it is incorporated, if that income is not reinvested in shipping assets; and (5) foreign oil-related income (not including extraction income) such as income from processing, transporting, or distributing oil or gas if not earned in the country of extraction or consumption. In addition, investments by controlled foreign corporations in U.S. property (such as loans to the U.S. parent) are generally subject to U.S. tax to the extent of previously untaxed earnings (sec. 956).

[3] *See Domestic International Sales Corporation Proposal of the U.S. Treasury Department,* 91st Cong., 2d Sess. (Comm. Print 1970); Staff of House Comm. on Ways and Means, 91st Cong., 2d Sess., *Summary of Testimony Presented at Foreign Trade Hearings Conducted by Committee on Ways and Means,* 114-118 (Comm. Print 1970).

[4] At the time Treasury first proposed DISC, the value of the dollar in relation to other currencies was fixed by agreement among the major trading countries of the world. It appeared that the dollar was overvalued, a factor that tended to reduce exports. In August 1971, President Nixon moved to let the dollar float against other currencies.

The Treasury Department anticipated that the proposed DISC legislation would work more in favor of companies without existing large foreign structures and extensive foreign tax credits. Larger corporations, the Department suggested, were able to reduce their U.S. tax liability under then-existing law on export earnings by using foreign manufacturing subsidiaries, by making the minimum distribution election (now repealed) provided in subpart F (practically speaking, available only to U.S. exporters with substantial investments in foreign manufacturing facilities), and by means of the foreign tax credit. The DISC legislation was intended to provide equivalent opportunities for tax deferral on foreign income to smaller corporations and corporations newly entering the export market or expanding their export sales.

Proposed Trade Act of 1970

The Administration's 1970 DISC proposal was included in the proposed Trade Act of 1970.[5] The proposed Trade Act passed the House but was not enacted. The bill, H.R. 18970, would have phased in the DISC provisions over three years. Deferral of tax would have been permitted on 25 percent of a DISC's income in 1970, 50 percent in 1971, and 100 percent in 1972.

In its report on the bill, the House Committee on Ways and Means stated that the expansion of exports was an important national goal and that the nation's previous strong surplus in export trade had to be restored in order to find a long-range answer to the balance-of-payments problem.[6]

The committee analyzed the effect of the disparate tax treatment given U.S. companies which exported goods abroad and U.S. companies which manufactured goods abroad in foreign subsidiaries, as follows: The exporter was discriminated against because he paid full U.S. taxes on a current basis; the U.S. company which manufactured abroad through a foreign subsidiary, on the other hand, generally was required to pay only the *foreign* taxes on its income on a current basis. Foreign taxes were found by the committee to average about 10 percentage points less than the regular U.S. corporate income tax. The committee also found that the existing tax structure encouraged the reinvestment of foreign earnings of foreign subsidiaries in plants or selling organizations located abroad, since this enabled the parent corporation to postpone the payment of the U.S. tax which would result if the foreign earnings were remitted to the United States. The DISC provisions of the bill were designed to remove the U.S. exporter's disadvantage by freeing him from U.S tax as long as he continued to use export income to expand his export sales organization or to invest his export income in production facilities, to the extent the facilities were used to produce goods in the United States for sales abroad.

The committee expressed the belief that the DISC provisions would encourage domestic companies to engage in export activities and also encourage those who, in any event, would engage in sales abroad to locate their manufacturing plants in the United States rather than in foreign countries.

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[5] H.R. 18970, 91st Cong., 2d Sess. (1970).

[6] *See* H. Rep. No. 1435, 91st Cong., 2d Sess. 7-8, 15-20, 58-59 (1970).

Citing various tax advantages provided by other countries to export trade, the committee stated that the deferral of U.S. tax for export companies was desirable so long as the use of the income in the export trade sales and production activities was continued. The committee also stated that the need to make U.S. exporters more competitive with exporters of other countries justified a clearer and more liberal allocation rule in determining the transfer price from domestic producers to export sales subsidiaries.[7]

In the committee's view, the DISC provisions could be expected to give rise to increased export sales in a number of ways. Exports might be increased through using part of the deferred tax resulting from the provisions to lower export prices.[8] More importantly, exports might be increased through increased promotional efforts by U.S. business. By increasing the profitability of exporting, the committee suggested, it would be possible to induce exporters to take positive actions to build up their export markets. Exports might also be increased because the DISC provisions would encourage plant location in the United States, rather than abroad. The DISC provisions would do so not only because of the deferral provided but also because the DISC would be permitted to make loans to its parent ("producer's loans") without the current payment of tax and, thus, could aid substantially in the expansion of plant facilities in the United States to be used for production for exporting.

The committee noted that the DISC bill included provisions especially designed to enable small businesses to take advantage of DISC benefits. For example, small businesses could qualify for DISC treatment though they left most of their selling arrangements to brokers who made sales for them on a commission. The committee believed that this would enable small businesses to obtain the advantage of economy of scale in their selling costs by arranging sales through a broker handling the sales of many small DISCs.

Finally, the committee suggested that, while larger companies would share with small- or medium-sized companies in the incentive to export provided by the DISC provisions, the stimulant in their case was likely to be less than that for small companies. Many larger companies already obtained the advantage of postponement of U.S. tax under existing law in the case of their sales abroad through the use of foreign subsidiaries or other arrangements.

1971 Administration proposal

The Administration reintroduced its 1970 DISC proposal in 1971.[9] The only change made in the 1971 proposal was the recommendation that it be fully effective in 1972 rather than be phased in over several years.

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[7] H. Rep. No. 1435, 91st Cong., 2d. Sess. 15-16 (1970).

[8] *Id.* at 18.

[9] *See Hearings on H.R. 10947 Before the Senate Comm. on Finance*, 92d Cong., 1st Sess. 14-77 (1971) (testimony of John B. Connally).

In connection with the 1971 proposal, the Treasury Department argued that DISC would serve the interests of labor, business, and consumers. Labor would benefit by the increase in U.S. jobs. Business would benefit because many U.S. businessmen, it was argued, would prefer to continue producing in the United States for export markets if the tax treatment of U.S. and foreign production could be equalized. Consumers would benefit because a higher level of exports was needed to support continued expansion of imports.

The Treasury Department also stated that it was becoming increasingly difficult to support a policy that the United States should be a model for other countries by fully taxing its export income. (The subpart F provisions enacted in 1962 were generally intended to subject export income of foreign base companies to tax currently.) According to the Department, the effect of this policy had been the erosion of production in the United States and the transfer of jobs to foreign manufacturing in cases in which tax factors influence decisions on the source of production. The Department reported that the United States had no followers in its effort fully to tax export income currently.

The Treasury Department described the DISC proposal as an effort to cut through the existing complexity of U.S. tax rules applicable to foreign income, and to provide forthrightly the opportunity for tax deferral by use of a domestic corporation rather than a foreign subsidiary.

The Revenue Act of 1971

In 1971, the House passed, as part of the Revenue Act of 1971, a set of DISC provisions broadly similar to those incorporated in the proposed Trade Act of 1970.[10] Unlike the earlier proposed DISC provisions, the 1971 DISC provisions passed by the House in H.R. 10947 generally were to apply only on an incremental basis, to export income in excess of a specified base. Under the House bill, deferral of tax was permitted on export income attributable to sales in excess of 75 percent of the average export sales of the corporate group to which the DISC belonged for the years through 1970. Deferral was granted on 100 percent of this export income.

In its report on the bill,[11] the House Committee on Ways and Means stated that the incremental approach had the advantage of concentrating the benefits of DISC treatment on firms which increased their exports and, thus, would make a greater contribution to resolving the U.S. balance of payments problem.

The Treasury Department opposed the incremental approach.[12] Noting that DISC was designed to induce companies to continue manufacturing in the United States for sale abroad, thus keeping jobs at home, the Treasury Department argued that this purpose would be largely frustrated by the incremental approach because many leading U.S. exporters had had declining or level exports in recent years. These companies would have no incentive to continue manufacturing in the United States for foreign markets under an incremental rule. In the case of other companies, the Treasury Department suggested, the incremental approach at best would provide only partial deferral treatment, so the effectiveness of DISC in keeping jobs at home would be greatly reduced.

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[10] *Compare* H.R. 10947, 92d Cong., 1st Sess. (1971) *with* H.R. 18970, 91st Cong., 2d Sess. (1970).

[11] *See* H. Rep. No. 533, 92d Cong., 1st Sess. 39, 58-59 (1971).

[12] *See Hearings on H.R. 10947 Before the Senate Comm. on Finance*, 92d Cong., 1st Sess. 14-16 (1971).

Further, the Treasury Department argued, the incremental approach overlooked the fact that, from a balance of payments standpoint, it was as important to maintain a dollar of existing export sales as to increase export sales by a dollar. The incremental approach would not provide any incentive to help arrest the decline in export sales. The incremental approach also, it was suggested, would penalize corporations who made substantial efforts to maintain or boost their exports in base period years. Finally, the incremental approach was criticized as too complex.

The Senate Finance Committee version of the bill containing the DISC provisions eliminated the incremental approach.[13] A provision was included instead that limited deferral of tax to 50 percent of the export profit of a DISC. The Senate Finance Committee made this change because the committee believed it would make the DISC provisions simpler and more equitable.

The Senate Finance Committee version of the bill also included a provision that would have terminated the DISC system after 10 years—in 1982.[14] This was intended to give Congress a subsequent opportunity to review the need for the DISC provisions in light of the changing international monetary situation.

In addition, the Senate Finance Committee amended the House bill to provide that, to the extent the controlled group, which included the DISC, invested profits of the DISC in foreign plant and equipment, deferral was to cease with respect to those profits. The committee was concerned that the tax-deferred profits of a DISC which were lent to the DISC's parent company (or affiliated company) might be used for investments in foreign plants and equipment by the parent (or domestic or foreign affiliate).

The DISC provisions enacted in the Revenue Act of 1971 followed closely the Senate amendments. An important change was the deletion of the built-in termination date.

In their reports on the legislation, both the House Committee on Ways and Means and the Senate Committee on Finance indicated that it was important to provide tax incentives for U.S. firms to increase exports not only because of the stimulative effects of such incentives but also to remove the existing tax disadvantage of U.S. companies engaged in export activities through domestic corporations.[15] The Treasury Department had described this tax disadvantage in connection with its 1970 and 1971 DISC proposals and the House Ways and Means Committee had reiterated it in its report on the proposed Trade Act of 1970.

The House and Senate Committees emphasized that other major trading nations encouraged exports. The Senate report added that both the House and Senate versions of the DISC provisions were designed to remove tax disadvantages for U.S. manufacturing, but to avoid granting undue tax advantages to DISCs.[16]

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[13] *See* S. Rep. No. 437, 92d Cong. 1st Sess. 12-13, 90-129 (1971).

[14] This period was reduced to seven years by a Senate floor amendment.

[15] H. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971).

Public Law 93-482 and the Tax Reduction Act of 1975

Public Law 93-482 amended the DISC provisions to enable a financing corporation to qualify as a DISC. This change was made because it came to Congress' attention that a corporation might want to have its sales operations in one DISC and its financing operations in another DISC. A corporation might adopt this corporate structure because it believed the structure would improve its ability to receive outside financing.[17]

The Tax Reduction Act of 1975 amended the DISC provisions to deny DISC benefits for the export of natural resources and energy products (i.e., products for which an allowance for cost depletion is provided) and for products subject to export control under the Export Administration Act of 1969. The Tax Reform Act of 1976 excluded from this amendment sales, exchanges, and other dispositions made after March 18, 1975, and before March 19, 1980, if made pursuant to a fixed contract.

The Tax Reform Act of 1976

Prior to the Tax Reform Act of 1976, legislative proposals were made to eliminate the DISC system entirely, or to give the President authority to terminate the application of the DISC provisions as part of a trade agreement between the United States and a foreign country.[18]

In considering the 1976 legislation, Congress examined the original DISC provisions at great length. It concluded that the DISC provisions had increased U.S. exports. While much of the increase in U.S. exports from 1971, when the DISC provisions were enacted, through 1975, had resulted from the devaluation of the U.S. dollar during that period, Congress believed that a significant portion of the increase resulted from the DISC legislation. This increase in exports, Congress concluded, provided jobs for U.S. workers and helped the U.S. balance of payments.

However, Congress also recognized that questions had been raised as to the revenue cost of DISC. In 1975, the system was estimated to have cost nearly $1.3 billion, and it was estimated that in 1976 the amount would have been $1.4 billion. Further, Congress believed that DISC was made less efficient because DISC benefits applied to all exports of a company, regardless of whether a company's products would be sold in similar amounts without export incentive and regardless of whether the company was increasing or decreasing its exports.

Congress concluded that the DISC program could be made more efficient and less costly while still providing the same incentive for increased exports and jobs.[19] The Tax Reform Act of 1976 made substantial changes in the DISC provisions. Perhaps most significantly, the legislation adopted an incremental approach to DISC benefits under which deferral generally was granted only to the extent of 50 percent of a company's income attributable to increases in its exports over a base period amount. Under prior law, tax generally was deferred on 50 percent of a DISC's income, regardless of whether its exports had increased.[20] The Act also reduced DISC benefits for military goods.

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[16] S. Rep. No. 437, 92d Cong., 1st Sess. 13 (1971).

[17] S. Rep. No. 1060, 93d Cong., 2d Sess. 4-5 (1974). *See also* H. Rep. No. 1402, 93d Cong., 2d Sess. (1974).

[18] *See, e.g.*, S. 1439, 93d Cong., 1st Sess. (1973); H.R. 15452, 93d Cong., 2d Sess. (1974); H.R. 17488, 93d Cong., 2d Sess. (1974).

[19] *See* H. Rep. No. 658, 94th Cong., 1st Sess., 263-64 (1975); S. Rep. No. 938, 94th Cong., 2d Sess., 291-92 (1976).

Tax Equity and Fiscal Responsibility Act of 1982

For corporate shareholders, the Tax Equity and Fiscal Responsibility Act of 1982 reduced the deferral rate on incremental DISC income from 50 to 42.5 percent. This change had the effect of reducing DISC tax benefits by 15 percent.

In 1982, Congress reduced corporate tax preferences, including DISC benefits, because (1) the Federal budget faced large deficits, (2) the Accelerated Cost Recovery System enacted in 1981 made some corporate tax preferences less necessary, and (3) there was increasing concern about the equity of the tax system, and cutting back corporate tax preferences was considered a valid response to that concern.[21]

Summary of Present DISC Rules

The profits of a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC is deemed to have distributed a portion (discussed below) of its income, thereby subjecting that income to current taxation in the shareholders' hands.[22] Federal income tax can generally be deferred on the remaining portion of the DISC's taxable income until the income is actually distributed to the DISC shareholders, a shareholder disposes of the DISC stock, the DISC is liquidated, distributed, exchanged, or sold, the corporation ceases to qualify as a DISC, or the DISC election is terminated or revoked.

Under the pre-1976 rules, a DISC was deemed to have distributed income representing 50 percent of its export profits and 100 percent of its non-export profits. In this way, under the prior rules, the tax deferral which was available under the DISC provisions was limited to 50 percent of the export income of the DISC. Under current rules, DISC benefits (deferral of tax on 42.5 percent of profits) are limited to income attributable to export gross receipts in excess of 67 percent of average export gross receipts in a 4-year base period. These provisions are known as the incremental provisions. The base period years are the fourth, fifth, sixth, and seventh preceding years. For example, the base period is 1973 through 1976 for taxable years beginning in 1981. If the taxpayer does not have a DISC in any year which would be included in the base period for the current year, the taxpayer is to calculate base period export gross receipts by attributing a zero amount of export gross receipts to that base period year. DISCs with adjusted taxable income of $100,000 or less are exempt from the incremental rule. This exemption is phased out as adjusted taxable income increases from $100,000 to $150,000.

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[20] "Small" DISCs were excluded from the incremental rules.

[21] Staff of Joint Comm. on Taxation, 97th Cong., *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982*, 30-32 (Joint Comm. Print 1982).

[22] In the typical case, a DISC is a wholly-owned subsidiary of a U.S. corporation, so distributions and deemed distributions from DISCs are typically subject to corporate tax and, eventually, to shareholder level tax when distributed to individuals.

The incremental provisions include special rules to deal with situations where a corporation has an interest in more than one DISC, or where a DISC and the underlying trade or business giving rise to the DISC income have been separated. The purposes of these rules are, first, to insure that in every year the base period export gross receipts which are attributable to a DISC for purposes of deemed distributions in the current year are appropriately matched with the current period export receipts of the DISC and, second, to prevent taxpayers from creating multiple DISCs, or swapping DISCs, to avoid the effect of the incremental rule.

To qualify for tax exemption, a DISC must be incorporated under the laws of any of the States or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the gross receipts and gross assets tests.

The gross receipts test requires that at least 95 percent of the corporation's gross receipts consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. Interest on any obligation which is a qualified export asset is also an export receipt. Export property must be manufactured, produced, grown, or extracted in the United States. Exports subsidized by the U.S. Government or exports intended for ultimate use in the United States do not qualify as export property. The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. However, energy resources, such as oil and gas and depletable minerals, are automatically denied DISC benefits under the Tax Reduction Act of 1975. That Act also eliminated DISC benefits for products the export of which is prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity. The Tax Reform Act of 1976 reduced DISC deferral on sales of military goods to half the amount which would otherwise be allowed.

The gross assets test requires that at least 95 percent of the corporation's assets qualify as export assets. Qualified export assets include inventories of export property, necessary operational equipment and supplies, trade receivables from export sales (including certain commissions receivable), producer's loans, working capital, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association. In certain situations, nonqualified assets and receipts may be distributed in order to satisfy these qualification requirements.

If a DISC fails to meet the qualifications for any reason, the DISC provisions provide for an automatic recapture of the DISC benefits received in previous years. Recapture of accumulated DISC earnings (because the DISC has become disqualified) is to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years).

The DISC provisions include special elective intercompany pricing rules, which may be used in lieu of the general intercompany pricing rules of the Code, in order to determine the profits which a DISC may earn on products which it purchases from a related company and then resells for export or which it sells on a commission basis. In general, a DISC may earn up to 4 percent of gross export receipts from a transaction or 50 percent of combined taxable income of the DISC and its related party; in either case, the DISC also earns 10 percent of export promotion expenses. Export promotion expenses include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships documented under the laws of the United States in those cases where law does not require use of such airplanes or ships. (Alternatively, the DISC and its related party may choose a price determined under the usual arm's-length rules.) Neither the 4-percent method nor the 50-50 method can be applied to cause a loss to the related supplier while the DISC is earning a net profit.

Under marginal costing rules, if the 50-50 method is used by the DISC, only the marginal or variable production and sales costs for the export property need be included in the computation of combined taxable income. In general, the benefits of marginal cost pricing are limited to instances where the variable cost margin on the DISC's export sales of a product is less than the full cost margin on the combined product sales by the DISC and the related supplier.

A DISC's taxable year need not conform to the taxable year of any of its shareholders. A wholly owned DISC will frequently have a taxable year ending one month after its parent's taxable year ends. This difference in taxable years allows an additional 11 months of deferral of income that is deemed distributed to the parent.

Source of Income from Export Sales

The United States taxes U.S. taxpayers on their U.S. and foreign source income, but allows a foreign tax credit for foreign taxes on foreign source income. The foreign tax credit limitation reflects the principle that the credit cannot exceed U.S. tax on foreign source income. In general, in calculating the limitation, most foreign source income is lumped together in a general category known as the "all other" category; a separate limitation or "basket" applies to certain income from deemed DISC distributions (and, separately, to certain interest), however. In most cases, an export sale will not attract foreign tax so long as the U.S. seller does not perform substantial activities in the country of destination. The reason for the separate limitation is that Congress, in enacting the original DISC legislation, did not intend to enable taxpayers to reduce U.S. taxes on low-foreign-taxed distributions from DISCs by crediting foreign taxes on non-DISC income against the U.S. tax on distributions from DISCs.

Income of a U.S. person that exports property produced in the United States directly (without using a DISC) is treated as income partly from within and partly from without the United States (sec. 863(b)). This income is not subject to the separate foreign tax credit limitation applicable to DISC income. To the extent that the income is from sources without the United States, it increases the taxpayer's foreign tax credit limitation in the general "all other" category, and thus the foreign taxes that the taxpayer may credit.

An approximation of the portion of income from a typical direct export sale that is foreign source income is 50 percent (see Treas. Reg. sec. 1.863-3(a)(2) (Example (2)). Therefore, a taxpayer with substantial excess foreign tax credits who can make an export sale directly (rather than through a DISC) without incurring foreign tax on the transaction may be subject to tax on only half the income from the export sale.

For example, a U.S. exporter who can make an export sale at a profit of $100 may be able to treat $50 of that income as foreign source. The taxpayer may be able to arrange the sale so that the $50 of foreign source income attracts no foreign tax. Given sufficient excess foreign tax credits, the sale will attract no U.S. tax, either. In that case, the taxpayer will be taxable on only the $50 of income that is U.S. source income.

By contrast, that exporter with excess foreign tax credits may be taxable on $58 of income if it routes the export sale through a DISC. The following table assumes a 17 percent deferral rate for combined taxable income (CTI) of DISC and parent. (This assumed 17-percent deferral rate forms the basis of the FSC proposal.)

CURRENT LAW—DISC—50/50 SPLIT OF CTI—SEC. 863(b)

(Exporter With Excess Foreign Tax Credits)

Parent		*DISC*	
U.S. source (taxable)	$25	Deferred	$17
Foreign source (exempt)	25	Deemed distribution	33
	50		50

Taxable:	
U.S. source income of parent	$25
Deemed distribution—separate basket	33
	58
Exempt:	
Foreign source income of parent	$25
Deferred in DISC	17
	42

Therefore, some exporters with excess foreign tax credits will choose not to route their export transactions through DISCs.

Income From Factoring Trade Receivables

When a seller of goods or services extends credit to a purchaser, the seller generally takes from the purchaser a transferable promise to pay in the future (an "account receivable" or a "trade receivable"). If the seller sells that receivable (the promise to pay the debt obligation) to a "factor," the factor earns "factoring" income when it collects the debt for its own account. The factor pays the seller less than the face value of the obligation, that is, the factor buys at a discount. The seller will sell at a discount for two reasons: first, to realize cash from the sale sooner than the buyer would pay for the goods or services, and second, to shift some of the risk of collecting the receivable. The seller would claim a loss from the disposition of the debt obligation for less than face value. The factor may assume some risk that the purchaser of goods or services will not pay its debt. In the typical case, the factor will earn some income because of the time value of money. That is, the reduced price that the factor pays the seller for the obligation will reflect an element of interest income.

Some taxpayers take the position that a controlled foreign corporation located in a tax haven can factor receivables arising from sales of goods or services by related parties without any U.S. tax. For this arrangement to avoid U.S. tax, certain issues would have to be resolved, including (1) whether the discount income is interest, (2) whether the purchase and collection of receivables is a trade or business within the United States, (3) whether the purchase of receivables is an investment in U.S. property, and (4) whether the discount is subpart F income.

There is authority that discount income earned by an active factoring business is not interest for purposes of the personal holding company rules (*Elk Discount Corp.*, 4 T.C. 196 (1944)), or for purposes of the Subchapter S rules (*Thompson* v. *Commissioner*, 73 T.C. 878 (1980)). The Service has held in one instance that discount income that a foreign subsidiary of a U.S. corporation earned was not interest income and was not subject to the anti-tax haven rules of Subpart F of the Internal Revenue Code as foreign personal holding income (private letter ruling 8338043, June 17, 1983).

If a foreign corporation buys receivables of U.S. obligors and then collects the amounts due, that foreign corporation may be engaged in U.S. business. If it is engaged in U.S. business, then its factoring income will be subject to U.S. tax. It is unclear under present law whether foreign corporations that buy obligations of U.S. persons and collect them are engaged in U.S. business (see private letter ruling 8338043, referred to above, which did not rule on the issue). Determination of this issue may depend on individual factual circumstances.

In addition, a U.S. shareholder of a controlled foreign corporation is taxable on its pro rata share of the increase in the taxable year of the foreign corporation's earnings invested in U.S. property (section 956). U.S. property generally includes any obligation of a U.S. person. However, a special rule excludes obligations of unrelated U.S. corporations (sec. 956(b)(2)(F)).

Factoring income of a controlled foreign corporation may be subject to other anti-tax haven rules of Subpart F. For example, factoring income may be foreign base company services income, which is income from services performed by or on behalf of a related person outside the country of incorporation of the controlled foreign corporation (sec. 954(e) (see private letter ruling 8338043, noted above, which did not rule on the issue)).

These rules applicable to controlled foreign corporations do not apply to DISCs. Three benefits arise when a DISC holds the receivables arising from export sales: (1) its parent gets cash, (2) the receivables help the DISC meet the qualified export assets test, and (3) the discount income is eligible for deferral. The discount, if treated as interest, would be treated as the DISC's income alone; it would not be included in combined taxable income for purposes of the 50-50 profit split. To the extent the discount income is not shared with the parent as combined taxable income, the DISC gets additional deferral (i.e., the DISC gets deferral on 42.5 percent of the full amount of the discount rather than 42.5 percent of half the discount).

B. The General Agreement on Tariffs and Trade (GATT)

Concern about U.S. obligations under the General Agreement on Tariffs and Trade (the "General Agreement" or GATT)[23] has motivated introduction of legislation dealing with the Domestic International Sales Corporation provisions.[24] The General Agreement became open for acceptance in October 1947; its provisions (as amended) apply to the United States, the developed countries of the free world, most of the world's developing countries, and a few communist countries.

Substantive Provisions in General

The thrust of the General Agreement is to prevent countries from favoring domestic goods over foreign goods. The typical method of favoring domestic goods is by import duties. The General Agreement also contains provisions designed to limit subsidies for domestic goods. First, countries must report to the GATT membership subsidies that reduce imports or increase exports (Article XVI:1 of the General Agreement). Article XVI is reproduced in Appendix B.

Second, the General Agreement proscribes export subsidies. It imposes different standards on export subsidies for primary products (such as minerals and agricultural commodities) and non-primary products. Any subsidy which increases the export of a primary product is not to result in a country having more than an equitable share of world export trade in that product (Article XVI(3)).

Countries are to cease granting subsidies on non-primary products when the subsidy results in export sales at lower prices than domestic sales (Article XVI:4). This standard for non-primary products is a "bi-level pricing" standard.

Remedies in General

If actions of one country nullify or impair any benefit that accrues to another country under the General Agreement, the injured country is to notify the offending country. If the two countries cannot solve the problem, the general membership of GATT is to investigate the matter, and make recommendations, or give a ruling. The general membership may authorize the injured country to suspend the concessions, such as reduced tariffs, it made to the offending country under the General Agreement.[25]

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[23] This pamphlet uses the term GATT to mean the agreement or the countries that subscribe to it, as the context requires.

[24] Statements of Senator Dole, 129 *Cong. Rec.* S11761 (August 4, 1983) and *id.* S12072 (September 13, 1983); Statement of Senator Danforth, *id.* S11766 (August 4, 1983).

[25] The text of the GATT provision governing these remedies, Article XXIII, is included in Appendix B.

The Illustrative List

In 1960, a GATT working party adopted an "illustrative list" of "practices generally . . . considered as subsidies" under Article XVI:4 (BISD (Basic Instruments and Selected Documents), 9 Suppl. p. 186). These included:

"(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises;" and"

"(d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption. . . ."

For GATT purposes, there is a distinction between "direct" and "indirect" taxes. Income taxes, such as the U.S. corporate income tax, are "direct" taxes, while some other taxes, such as Value Added Taxes (V.A.T.), are "indirect" taxes. Therefore, forgiveness of corporate income tax on export profits may violate GATT rules, while remission of a V.A.T. may not violate those rules.

The members of the European Economic Community (and other countries) generally impose high Value Added Taxes on goods consumed locally, but they rebate those taxes for exported goods. The staff is not aware of any challenge to this practice of EEC member countries.[26]

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[26] For criticism of the effect of this distinction between direct and indirect taxes, see the remarks of Senator Long in *Hearings before the Committee on Finance, U.S. Senate, Nomination of John B. Connally, of Texas, to be Secretary of the Treasury,* January 28 and February 2, 1971, at 39-40. See also U.S. Department of the Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation, 1976 Annual Report* at 30-32, and Jackson, "The Jurisprudence of International Trade: The DISC Case in GATT," 72 *Am. Journal of Int'l Law* 747, 751 & n.15.

C. GATT's reaction to DISC

The Treasury Department first proposed DISC to Congress in 1970. Before DISC's enactment, the European Economic Community (EEC) indicated its view that DISC constituted a "tax privilege" and a "tax incentive to exports" and "would be contrary to the United States' commitments under the General Agreement."[27] Canada, Switzerland, and Sweden also expressed concern about the DISC proposal.

The DISC provisions became effective on January 1, 1972; early in that year, the EEC formally requested consultation with the United States about DISC. The United States then sought consultations with France, Belgium and the Netherlands with respect to those countries' tax systems, which exempted profits of foreign sales corporations. The United States argued that those countries' territorial tax systems were as generous as or more generous than DISC for exports and that either all were legal under GATT or all were illegal.

In general, these three countries use a "territorial" system of taxation in which profits generated by undertakings operated abroad are exempt from home-country tax.[28] In general, these three countries have low taxes (or no taxes) on foreign profits brought back into the country. Each of these countries, in principle, generally requires arm's-length pricing between related parties, but it is not clear how well these countries enforce or enforced the arm's-length standard.

By 1973, both the United States and the EEC had formally complained to the GATT membership about the alleged tax export subsidies. The GATT Council directed that a Panel of experts examine DISC and the tax practices of France, Belgium and the Netherlands.

In late 1976, the GATT Panel issued reports on the tax practices of all four countries.[29] The Panel concluded that the DISC legislation conferred a tax benefit essentially related to exports, and that this would tend to lead to an expansion of export activity. The Panel noted that the DISC legislation was intended to increase United States exports and noted that the Treasury Department had reported that DISC had in fact increased exports. The Panel further noted that the deferral of tax under the DISC legislation did not attract the interest component of the tax normally levied for late or deferred payment and therefore concluded that, to this extent, the DISC legislation constituted a partial exemption which was either "a remission" or "an exemption" (or both) that was improper under the illustrative list of 1960. The Panel indicated that remissions and exemptions were generally to be considered as subsidies in the sense of Article XVI:4.

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[27] Note on Exchange of Views, GATT Doc. L/3574 (September 13, 1971). For discussions of GATT's reaction to DISC; see Cohen and Hankin, "A Decade of DISC: Genesis and Analysis," 2 *Va. Tax Rev.* 7 (1982), Jackson, "The Jurisprudence of International Trade: The DISC Case in GATT," 72 *American Journal of International Law* 747 (1978); Kwako, "Tax Incentives for Exports, Permissible and Proscribed: An Analysis of the Corporate Income Tax Implications of the MTA Subsidies Code," 12 *Law & Policy in Int'l Bus.* 676 (1980).

[28] This exemption applies not only to exports, but also to purely foreign transactions. For example, profits of a non-French branch (or subsidiary) of a French corporation would generally be exempt from French tax, and would be subject to a low rate of tax (that could be zero in certain cases) on repatriation.

[29] Appendix B of this pamphlet reproduces in full the Panel's conclusions with respect to DISC.

The Panel indicated that the DISC legislation could be presumed to result in bi-level pricing. The Panel considered that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort and (c) increase of profits per unit. The Panel expected that all of these effects would occur and that a concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel therefore concluded that the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4 with respect to non-primary products. The Panel did not examine whether the DISC legislation would give the United States a disproportionate share of the world market in primary products (in terms of Article XVI:3).

The Panel did not accept the United States argument that it had introduced the DISC legislation to correct an existing distortion created by tax practices of certain other contracting parties. The Panel said that that one distortion could not be justified by the existence of another one. In conclusion, the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other countries were entitled to expect under the General Agreement.

On the day that the Panel issued its report on DISC, the three Panels examining the tax practices of France, Belgium, and the Netherlands issued their reports. (The membership of these three Panels was identical to that of the DISC Panel.)

The GATT Panel reports on the tax systems of France, Belgium, and the Netherlands are similar in their analysis and conclusions to the report on DISC.[30] The GATT Panel reports on these three tax systems noted that their application of the territoriality principle allowed some part of export activities to be outside the scope of home country taxes. In this way each country created a possibility of a pecuniary benefit to exports. The Panel did not find it significant (1) that territoriality was a long-standing practice in each country, not created to benefit exports or (2) that each country's territorial system exempted income from foreign investment generally, and not just income from export activity.

The Panel also noted that taxation of dividends from abroad at a nominal rate preserved these tax benefits for exports. The Panel concluded in each case that there was a partial exemption from direct taxes which was either "a remission" or "an exemption" (or both) that was improper under the illustrative list of 1960. The

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[30] These reports are "Income Tax Practices Maintained by France," GATT Doc. No. L/4423 (Nov. 2, 1976); "Income Tax Practices Maintained by Belgium," GATT Doc. No. L/4424 (Nov. 2, 1976); GATT, "Income Tax Practices Maintained by the Netherlands," GATT Doc. No. L/4425 (Nov. 2, 1976). Appendix B of this pamphlet contains excerpts from the Panel Report on France.

Panel indicated that remissions and exemptions were generally to be considered as subsidies in the sense of Article XVI:4. The Panel added (with respect to each case) that bi-level pricing had probably occurred and concluded that each country's tax practices in some cases had effects which were not in accordance with its obligations under Article XVI:4 with respect to non-primary products. The Panel noted that each country might allow deviations from the arm's-length pricing principle in calculating the allocation of profits between companies and their foreign operations. The Panel found in each case that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.

Belgium and France contested the findings with respect to their tax practices with the argument that exportation (that a tax system could subsidize in violation of GATT) ends at the customs frontier of the importing country. The argument of Belgium was as follows:

"It is clear that export activities end the moment that the foreign importer takes possession of the exported products. All further activities take place at the level of the importer, whether the importer is a fully independent company, or a branch or subsidiary company. Such activities do not enter into the framework of export operations and therefore fall outside the scope of Article XVI:4."[31]

There was no GATT action on these Panel reports until December 1981. The delay was due in part to negotiations that led up to adoption, in 1979, of an "Agreement on Interpretation and Application of Articles VI, XVI, and XXIII" of the General Agreement.[32] This agreement is generally known as the "Subsidies Code." An Annex to that Agreement contained an updated "Illustrative list of export subsidies," which included the following item:

"(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises."

The inclusion of "deferral" in this item represented a significant departure from the 1960 list. One footnote[33] to that item explained that deferral need not amount to an export subsidy where appropriate interest charges are collected. That footnote also indicated (1) that the reference to deferral was not intended to prejudge the DISC case; (2) that the arm's-length pricing standard should apply in transactions between exporting enterprises and foreign buyers under common control; and (3) that this item was not intended to limit measures to avoid the double taxation of foreign source income.

At a meeting in December 1981, the GATT Council adopted all four panel reports but with three qualifications.[34] First, GATT does not require an exporting country to tax economic events that take place outside its territorial limits. Second, GATT (Article XVI:4) requires arm's-length pricing in transactions between exporting enterprises and foreign buyers under common control.

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[31] GATT Doc. C/98, March 14, 1977.

[32] See Agreements Reached in the Tokyo Round of the Multilateral Trade Negotiations, H.R. Doc. No. 153, 96th Cong., 1st Sess., pt. 1 (1979).

[33] The text of that footnote appears in Appendix B.

[34] The text of the agreement is found in Appendix B.

Third, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

This agreement reflects some of the concepts of the 1979 Subsidies Code. The effect of this agreement on DISC is not clear. In December 1981, David R. MacDonald, Deputy U.S. Trade Representative, stated his office's position that DISC did not violate the principles of GATT, and that this agreement left the United States "under no obligation to modify or eliminate the DISC."[35] In October 1982 the Deputy U.S. Trade Representative informed the GATT Council that the Administration intended to propose legislation to address the concerns that GATT members had with DISC. In March 1983 the President's Cabinet Council on Commerce and Trade approved a proposal for a tax replacement for DISC. That proposal formed the basis for S. 1804 and an identical House bill, H.R. 3810.

The Treasury Department's annual report on DISC for 1981, issued in July 1983, expresses the Administration's official position on the GATT controversy:

"For several years, the provisions of the DISC legislation have been the subject of a dispute between the United States and other General Agreement on Tariffs and Trade (GATT) signatories. Those signatories contend that DISC amounts to an illegal export incentive which violates the GATT. The DISC was found to be an illegal export subsidy by a GATT panel in 1976 along with similar tax practices of Belgium, France, and the Netherlands. While the United States has never conceded that DISC violates the GATT, the United States agreed to the adoption of the GATT panel reports subject to the understanding that GATT signatories need not tax export income generated by economic processes outside their territorial limits, as long as arm's-length pricing principles are observed in transactions between related parties. The understanding also states that the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign source income.

"The DISC dispute remains a serious irritant in U.S. trade relations with other countries, particularly the European Community. Thus, the United States informed the GATT Council in October, 1982 that it would propose to Congress legislation that would address the concerns of its trading partners. In March, 1983, the Administration announced the general elements of a tax alternative to DISC. Legislation on the proposed alternative was being drafted as this report was prepared."[36]

That legislation is S. 1804 (and the companion House bill, H.R. 3810).

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[35] 15 *Tax Notes* 884 (June 14, 1982).

[36] Department of the Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation, 1981 Annual Report*, 6-7 (July 1983).

III. EXPLANATION OF S. 1804 (FOREIGN SALES CORPORATION ACT OF 1983)

Overview

The bill would provide that a portion of the export income of an eligible foreign sales corporation (FSC) would be exempt from Federal income tax. It would also allow a domestic corporation a 100 percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there would be no corporate level tax imposed on a portion of the income from exports.

Under the GATT rules, an exemption from tax of export income is permitted only if the economic processes which give rise to the income take place outside the United States. In light of these rules, the bill would provide that a FSC must have a foreign presence, it must have economic substance, and that activities that give rise to the export income must be performed by the foreign sales corporation outside the U.S. customs territory. Furthermore, the income of the foreign sales corporation must be determined according to transfer prices specified in the bill: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of such arm's-length prices.

The bill would provide that the accumulated tax-deferred income of existing DISCs would be deemed previously taxed income and, therefore, would be exempt from taxation.

Small exporters may find it difficult to comply with certain of the foreign presence and economic activity requirements. The bill would provide, therefore, two options to alleviate the burden of the foreign presence and economic activity requirements to eligible small businesses: the interest-charge DISC and the small FSC.

Foreign sales corporation

To qualify as a FSC, a foreign corporation must have a foreign presence. In order to determine whether a corporation has a foreign presence, the bill would provide an objective test—the corporation must satisfy each of the following six requirements: The corporation must (1) be created or organized under the laws of any foreign country or possession of the United States (a term that includes Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States, but does not include Puerto Rico, because the United States includes Puerto Rico for purposes of the bill),[37] (2) have no more than 25 shareholders at any time during the taxable year, (3) not have any preferred stock outstanding at any time during the taxable year, (4) maintain an office located outside the United States, maintain a set of the permanent books of account at such office, and maintain within the United States the records required of a domestic corporation for tax purposes, (5) at all times during the taxable year have a board of directors which includes at least one individual who is not a resident of the United States, and (6) not be a member at any time during the taxable year of any controlled group of corporations of which a DISC is a member.

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[37] In other words, the corporation must be formed under the laws of a jurisdiction outside U.S. customs territory.

In addition to the above requirements, a FSC must make an election to be treated as a FSC.

Exempt foreign trade income

A portion of the foreign trade income of a FSC would be exempt from Federal income tax. To achieve this result, the exempt foreign trade income would be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. The portion of foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the amount of foreign trade income earned by the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, then exempt foreign trade income is 34 percent of the foreign trade income derived from a transaction. If, however, the income earned by the foreign sales corporation is determined under the special administrative pricing rules, then the exempt foreign trade income is 17/23 of the foreign trade income derived from the transaction.

Exempt foreign trade income is an exclusion from gross income of the FSC. Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by the FSC from a transaction would be allocated on a proportionate basis between exempt and nonexempt foreign trade income. Thus, deductions allocable to exempt foreign trade income could not be used to reduce the taxable income of the FSC.

In general, no tax credits other than withholding or foreign tax credits would be allowed to a FSC.

Foreign trade income

Foreign trade income is defined as the gross income of a FSC attributable to foreign trading gross receipts. Foreign trade income includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products or services exported by others.

All foreign trade income, other than exempt foreign trade income, would be treated as income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Furthermore, foreign trade income would be treated as derived from sources within the United States rather than as foreign source income. Thus, foreign trade income other than exempt foreign trade income would be taxed currently and treated as U.S. source income for purposes of the foreign tax credit limitation. This nonexempt foreign trade income would be either 6/23 or 66 percent of foreign trade income, depending on the pricing method used in arriving at foreign trade income.

A FSC may not credit or deduct foreign income, war profits, or excess profits taxes paid or accrued with respect to foreign trade income (whether exempt or nonexempt). The corporate shareholder of a FSC would be not eligible for a deemed-paid foreign tax credit with respect to foreign trade income. Two new categories of income would each be subject to separate foreign tax credit limitations (like DISC distributions under current law): (1) taxable income attributable to foreign trade income (at the FSC level), and (2) distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income (at the level of the FSC's shareholder). By virtue of these separate limitations, no increase in the FSC's foreign source income in the general "all other" category would result from foreign trade income.

Foreign trading gross receipts

In general, foreign trading gross receipts would mean the gross receipts of a FSC which are attributable to the export of certain goods and services (similar to the qualified gross receipts of a DISC under present law). Foreign trading gross receipts of a FSC are the gross receipts which are (1) from the sale, exchange or other disposition of export property, (2) from the lease or rental of export property for use by the lessee outside the United States, (3) for services which are related and subsidiary to the sale, exchange, disposition, lease or rental of export property, (4) for engineering or architectural services for construction projects located outside the United States, or (5) for the performance of managerial services that relate to the production of gross receipts.

For the FSC to have foreign trading gross receipts, two additional requirements must be met—the foreign management and foreign economic process requirements. (These requirements do not apply to small FSCs, described below.) A FSC would be treated as having foreign trading gross receipts only if the management of the corporation during the taxable year takes place outside the United States and only if the economic processes with respect to particular transactions take place outside the United States. (The management test applies to functions of the FSC for the taxable year. In contrast, the economic process test generally applies to every transaction on a transaction-by-transaction basis).

Foreign management.—The requirement that the FSC be managed outside the United States would be treated as satisfied for a particular taxable year if (1) all meetings of the board of directors of the corporation and all meetings of the shareholders of the corporation are outside the United States, (2) the principal bank account of the corporation is maintained outside the United States at all times during the taxable year and, (3) all dividends, legal, and accounting fees, and salaries of officers and members of the board of directors of the corporation disbursed during the taxable year are disbursed out of bank accounts of the corporation outside the United States.

Foreign economic processes.—Economic processes are treated as taking place outside the United States if two requirements are met. The first requirement is that, with respect to any transaction, the

FSC must participate outside the United States in the solicitation (other than advertising), the negotiation or the making of the contract relating to the transaction. This test can be met if either the FSC or any person acting under contract with the FSC has performed one or more of these activities outside the United States.

The second requirement is that the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50 percent of the total direct costs incurred by the FSC with respect to the transaction (or that the FSC meet an alternative 85-percent test, described below).

The term "total direct costs" (the denominator of the fraction) means, with respect to any transaction, the total direct costs incurred by the FSC attributable to the activities relating to the disposition of export property. These activities are those performed at any location within or without the United States by the FSC or any person acting under contract with the FSC. The term "foreign direct costs" (the numerator of the fraction) means the portion of the total direct costs incurred by the FSC which are attributable to activities performed outside the United States. Although the activities must be performed outside the United States, either the FSC or any person acting under contract with the FSC may perform the activities.

For purposes of the foreign direct-cost test, the costs of five activities relating to the disposition of export property are considered. The activities are (1) advertising or sales promotion, (2) the processing of customer orders and the arranging for delivery (outside the United States) of the export property, (3) transportation from the time of acquisition by the FSC to the delivery to the customer, (4) the determination and transmittal of the final invoice or statement of account and the receipt of payment, and (5) the assumption of credit risk. In the case of a commission relationship, the transportation test is determined from the beginning of the commission relationship rather than from the time of acquisition by the FSC.

The requirement that the foreign direct costs incurred by the FSC equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85 percent test. Under this alternative test a corporation would be treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five activities relating to disposition of the export property equal or exceed 85 percent of the total direct costs of at least two of those five activities.

For example, if the foreign direct costs (incurred by a FSC with respect to a transaction) attributable to advertising and sales promotion, and the assumption of credit risk are 85 percent or more of the total direct costs of these activities, the foreign direct cost test would be satisfied. With respect to this transaction, none of the direct costs of the other activities, for example, the processing of customer orders and arranging for delivery outside the United States of the export property, need be foreign direct costs.

Burden of proof.—The burden of proof with respect to the foreign management and economic process requirements would be shifted to the Secretary of the Treasury if a written statement addressing the issue has been filed by an officer of the corporation. The statement to be filed with the Secretary must be made by an officer of the FSC who is a citizen and resident of the United States, and must be made under penalty of perjury. Furthermore, the statement must declare that the corporation meets the economic process requirements and the foreign management requirements and must specify how the requirements have been met for the particular transactions.

Excluded receipts.—Certain receipts are not included in the definition of foreign trading gross receipts. First, certain receipts are excluded on the basis of use; also, subsidized receipts and certain receipts from related parties are excluded. Examples of such receipts include the receipts of a FSC from a transaction (1) if the export property or services are for ultimate use in the United States or are for use by the United States and the use by the United States is required by law or regulation, (2) if the transaction is accomplished by a subsidy granted by the United States, or (3) if the receipts are from another FSC which is a member of the same controlled group.

Second, one-half of the receipts from military property are excluded from the definition of foreign trading gross receipts.

Third, investment income and carrying charges are excluded from the definition of foreign trading gross receipts. Carrying charges would mean not only amounts normally considered carrying charges but also any amount in excess of the price for an immediate cash sale and any other unstated interest. Thus, a taxpayer could not artificially increase foreign trade income through hidden carrying charges or unstated interest.

Income attributable to excluded receipts would not be foreign trade income and, therefore, no portion of such income would be exempt; furthermore, a corporate shareholder would not get a dividends-received deduction for distributions attributable to such income. For example, investment income and carrying charges would be included in the taxable income of the FSC and, therefore, subject to full U.S. tax. Distributions to a corporate shareholder from earnings and profits attributable to the investment income and carrying charges would be fully taxed again (to the corporate shareholder) because there would be no dividends-received deduction. In other words, the investment income and carrying charges would be subject to tax at the FSC level, the corporate shareholder level and, like all other dividends from the corporate shareholder to its individual shareholders, also at the individual level. At the FSC level, investment income would be eligible for foreign tax credits.

Transfer pricing rules

The pricing principles that govern the determination of the taxable income of a FSC are intended to comply with the GATT rules. If export property is sold to a FSC by a related person, the taxable income of the FSC and the related person is based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae which are intended to approximate arm's-length pricing. Taxable income may be based upon a transfer price that allows the FSC to derive taxable income attributable to the sale in an amount which does not exceed the greatest of: (1) 1.83

percent of the foreign trading gross receipts derived from the sale of the property; (2) 23 percent of the combined taxable income of the FSC and the related person (these two pricing rules are termed the administrative pricing rules); and (3) taxable income based upon the actual sales price, but subject to the rules provided in section 482. Neither administrative pricing rule can cause a loss to the related supplier while the FSC is earning a net profit.

In order to use the special administrative pricing rules, a FSC must meet two requirements. The first requirement is that *all* of the activities with respect to which the direct costs are taken into account for the 50 percent foreign direct costs test must be performed by the FSC or by another person acting under contract with the FSC. These five activities are advertising and sales promotion, processing of customer orders and arranging for delivery of the property, transportation, billing and receipt of payment, and the assumption of credit risk. The second requirement for use of the administrative pricing rules is that *all* of the activities relating to the solicitation (other than advertising), negotiation and making of the contract for the sale must be performed by the FSC (or by another person acting under contract with the FSC). These two requirements can be met wherever the activities are performed. The activities do not have to be performed outside the United States. It is only necessary that the activities be performed by the FSC or by another person acting under contract with the FSC.

To summarize, to be treated as having foreign gross receipts and hence foreign trade income, the foreign costs of certain activities relating to the disposition of export property must be substantial (either 50 percent of the cost of all five activities or 85 percent of the cost of two of the activities). To use the administrative pricing rules, all five of the activities must be performed by the FSC or by another person acting under contract with the FSC. Furthermore, other activities (solicitation, negotiation, and making of the contract of sale) must be performed by the FSC or by another person acting under contract with the FSC.

Distributions to shareholders

Distributions to shareholders must be made first out of foreign trade income. The FSC may have income that is not foreign trade income, for example, investment income. Distributions would be treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any distribution made by a FSC which is made out of earnings and profits attributable to foreign trade income to a shareholder which is a foreign corporation or a nonresident alien individual would be treated as a distribution which is effectively connected with the conduct of the trade or business conducted through a permanent establishment of the shareholder within the United States. Thus, such distributions would be generally subject to Federal income tax.

Dividends received from a FSC

A domestic corporation would be allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. Thus, there would be no corporate level tax on exempt foreign trade income and only a single-level corporate tax (at the FSC level) on foreign trade income other than exempt foreign trade income. To the extent a corporate shareholder of a FSC distributes dividends attributable to foreign trade income to its individual shareholders the amounts would be taxed. Likewise, noncorporate shareholders of a FSC would be taxed currently on all dividends received from a FSC.

A dividends-received deduction would not be allowed, however, for distributions attributable to other earnings and profits. These distributions would therefore be taxed currently to the shareholders, corporate or noncorporate, of the FSC.

Other definitions and special rules

Factoring of trade receivables.—The bill would add a new category of income to the definition of foreign personal holding company income (which is used in taxing income to the United States shareholders of foreign personal holding companies and controlled foreign corporations (under Subpart F)). This category of income is income from an account receivable or evidence of indebtedness arising out of the disposition of property described in section 1221(1) (which includes stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), or the performance of services, by a related person. This rule would apply whether or not the related person is a U.S. person. The effect of this rule is to treat factoring as a tax-haven activity under the Subpart F rules.

In addition, the bill would amend the definition of U.S. property (in Code sec. 956) to include any account receivable or evidence of indebtedness arising out of the disposition of property described in section 1221(1), or performance of services, by a related U.S. person. This rule would apply notwithstanding the rule of current law that excludes from the definition of "U.S. property" obligations of unrelated U.S. corporations. The effect of this amendment would be to treat this factoring activity like certain other transfers of cash from controlled foreign corporations to their U.S. shareholders.

Export property.—In general, the term export property means property manufactured or produced in the United States for sale, lease or rental in the ordinary course of trade or business for use outside the United States, and not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

The term export property does not include (1) property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member, (2) patents and other intangibles, (3) oil or gas or any primary product thereof, or (4) products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply. Coal and uranium products specifically excluded from the definition of export property under the DISC rules would not be excluded under this bill, however.

Cooperatives.—Agricultural products marketed through cooperatives are subject to special rules. Fungible agricultural products marketed through pooling arrangements of an exempt farmers' cooperative are treated as meeting the requirements that they be export property to the extent that the products are sold for use outside the United States. Each member of the pool is considered as a producer of the property to the extent of his or her ratable share of the product based upon his or her contribution of products to the pool. The special rule does not apply to any products which are sold by the cooperative through a FSC or DISC of which the cooperative is a shareholder. A cooperative marketing the products of its patrons is treated as acting as the agent of the patrons regardless of any formal transfer of title to the cooperative.

Gross receipts.—In general, the term gross receipts means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of a trade or business, and gross income from all other sources.

In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of these provisions as gross receipts would be the gross receipts on the sale, lease, or rental of the property on which the commissions arose.

Investment income.—For purposes of these provisions the term investment income means dividends, interest, royalties, annuities, rents (other than rents from the lease or rental of export property for use by the lessee outside the United States), gains from the sale or exchange of stock or securities, gains from futures transactions in any commodity, amounts includible in computing the taxable income of the corporation under the estate and trust rules and gains from the sale or disposition of any interest in an estate or trust.

Grouping of transactions.—Many of the tests required under the foreign management and economic processes requirement are to be applied on a transaction-by-transaction basis. However, regulations would provide that transactions may be grouped based upon product lines or recognized industry or trade usage. The regulations could permit different groupings for different purposes. Such flexibility may be important when grouping transactions for purposes of the direct-cost test, for example.

Controlled group of corporations.—A controlled group of corporations is defined as in section 1563(a) except that a 50 percent ownership test is substituted for the 80 percent test.

Foreign tax credit limitation of related parties.—The bill would provide a special rule governing the source of income earned by a person related (within the meaning of section 482) to a FSC from transactions giving rise to foreign trading gross receipts of a FSC. That related person's foreign source income from such a transaction could not exceed the amount which would be treated as foreign source income earned by that person if the analogous DISC pricing rule applied. For this purpose, the DISC gross receipts pricing rule of Code section 994(a)(1) is analogous to the bill's gross receipts pricing rule in proposed section 925(a)(1); the DISC combined taxable income pricing rule of Code section 994(a)(2) is analogous to the bill's combined taxable income pricing rule in proposed section 925(a)(2); and the DISC section 482 pricing rule of Code section

994(a)(3) is analogous to the bill's section 482 pricing rule in proposed section 925(a)(3).

This special rule governing the source of income and thus the foreign tax credit limitation of parties related to a FSC is necessary to prevent revenue loss. The table below illustrates the application of the bill absent this special rule to a FSC's parent with excess foreign tax credits that exports by selling to its FSC. The table presupposes that the 50 percent of the parent's income from the export sale is foreign source income (as might well be the case under Code sec. 863(b) absent the bill's special rule). It presupposes that the parent has sufficient excess foreign tax credits to offset U.S. tax on all the foreign source income from the export sale. It also presupposes that the export sale is subject to the bill's combined taxable income (CTI) rule (proposed section 925(a)(2)).

FSC—77/23 SPLIT OF CTI ABSENT RESOURCING RULE

(Exporter With Excess Foreign Tax Credits)

Parent		*FSC*	
U.S. source (taxable)	$38.50	Exempt	$17
Foreign source (exempt)	38.50	Taxable	6
	77.00		23

Taxable:	
U.S. source income of parent	$38.50
Taxable income of FSC	6.00
	44.50
Exempt:	
Foreign source income of parent	$38.50
Exempt in FSC	17.00
	55.50

Under current law, the parent's share of combined taxable income is $50 (as illustrated in the table in the Present Law section of this pamphlet). The parent's foreign source income might be $25 under present law. Exemption of $55.50 under the bill (absent the special rule) would exceed the combination of exemption and deferral of $42 for a parent of a DISC with excess credits under current law (with a 17 percent deferral rate).[38] To maintain parity with DISC, the bill would reduce the foreign source income of the parent in the example above from $38.50 to $25, which would result in an exemption of $42 (comparable to present law). The parent's U.S. source income would increase, under the special rule of the bill, from $38.50 to $52. The following table illustrates the effect of the bill's resourcing rule.

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[38] In the Present Law section of this pamphlet, the taxpayer with excess credits was taxable on $58: $25 of U.S. source income plus a $33 deemed DISC distribution, but paid no tax on $25 of foreign source income or on $17 deferred in the DISC.

FSC—77/23 SPLIT OF CTI WITH RESOURCING RULE

(Exporter With Excess Foreign Tax Credits)

Parent		*FSC*	
U.S. source (taxable)	$52	Exempt	$17
Foreign source (exempt)	25	ECI	6
	77		23

Taxable:	
U.S. source income of parent	$52
ECI of FSC	6
	58
Exempt:	
Foreign source income of parent	$25
Exempt in FSC	17
	42

Participation in international boycotts.—The exempt foreign trade income of a FSC would be limited if the FSC participates in international boycotts and to the extent that any illegal bribe, kickback or other payment is made to an official employee or agent of a government. Regulations would provide rules similar to those that apply to the deemed distributions of a DISC under section 995(b)(1)F).

Election.—A corporation could elect to be treated as a FSC, or a small FSC, for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year. The bill would provide that the Secretary of the Treasury has authority to consent to the making of an election at other designated times. The election would be made in a manner prescribed by the Secretary. The election would be valid only if all shareholders as of the first day of the first taxable year for which the election is effective consent to the election.

Small business

In order to provide relief for small businesses who may find the foreign presence and economic activity burdensome, the bill would provide two alternatives to the FSC: the interest charge DISC and the small FSC.

Interest charge DISC.—A DISC may continue to defer income attributable to $10 million or less of qualified export receipts. Deemed distributions relating to base period exports (the incremental rule) and to one-half of the DISC's income would be eliminated; thus, substantially all of the DISC's income attributable to $10 million or less of qualified export receipts could be deferred. However, unlike the present law DISC, an interest charge would be imposed on the shareholders of the DISC. The amount of the interest would be based on the tax otherwise due on the deferred income computed as if the income were distributed. The interest rate would be tied to the T-bill rate.

The tax that would otherwise be due on the deferred income, termed the shareholder's DISC-related deferred tax liability, means, with respect to the year of the shareholder, the excess of the tax liability for the year computed as if the deferred DISC income were included in income over the actual tax liability for the year. This amount would be computed without regard to carrybacks to such taxable year. The Secretary of the Treasury is directed to prescribe regulations to provide any adjustments necessary or appropriate in the case of net operating losses, credits, and carryovers.

Deferred DISC income generally means the excess of accumulated DISC income at the beginning of the taxable year over the amount by which actual distributions out of accumulated DISC income exceed the current year's DISC income (termed distributions-in-excess-of-income). For shareholders of the DISC whose taxable year is different from that of the DISC, deferred DISC income is measured from the computation year; with respect to any taxable year of the shareholder, the computation year is the taxable year of the DISC which ends within the shareholder's preceding taxable year.

The rate of interest imposed on the shareholder's DISC-related deferred tax liability is determined by reference to a base period T-bill rate; this would mean the annual rate of interest that is equivalent to the average investment yield of U.S. T-bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with the close of the taxable year of the shareholder. The Secretary of the Treasury would be expected to publish this rate in October of each year. The interest a taxpayer is required to pay under this provision would be due at the same time the shareholder's regular tax is required to be paid.

Taxable income of the DISC attributable to qualified export receipts that exceed $10 million would be deemed distributed. Thus, if export receipts exceed $10 million, the DISC would not be disqualified; there would merely be no deferral of income attributable to the excess receipts. DISCs which are members of the same controlled group would be treated as a single corporation for purposes of the $10 million-rule.

Small FSC.—A FSC could elect to be a small FSC with respect to a taxable year provided that it is not a member at any time during the taxable year of a controlled group of corporations which includes a FSC (unless the other FSC has also made a small FSC election).

In order to have foreign trading gross receipts, a small FSC need not meet the foreign management and foreign economic process requirements. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts that exceed $2,500,000 would not be taken into account. No exception to the requirements for use of the administrative pricing rules is provided for small FSCs. Because these activities may be performed by the FSC or by another person acting under a contract with the FSC and need not be performed outside the United States, this may not be as onerous a requirement to small exporters as the foreign management and economic process requirements would be.

All small FSCs which are members of the same controlled group would be treated as a single corporation.

If the foreign trading gross receipts of a small FSC exceed the $2,500,000 limitation, the corporation may select the gross receipts to which the limitation is allocated. This provision would allow a taxpayer to choose, for example, to allocate the limitation to gross receipts attributable to transactions where the profit margin is high; in this case, the amount of exempt income would be greater than if the limitation were allocated to low margin transactions.

Taxable year of DISC and FSC

The taxable year of any DISC or FSC would be required to conform to the taxable year of the majority shareholder (or group of shareholders with the same taxable year) as determined by voting power. Special rules are provided for where more than one shareholder or shareholder groups have the highest percentage of voting power, and for subsequent changes of ownership.

Transition rules for DISCs

The taxable year of any DISC which begins before January 1, 1984 and which would otherwise include January 1, 1984 would close on December 31, 1983. To the extent that any underpayment of estimated tax is created or increased by this provision, no penalty would be imposed.

Accumulated DISC income which is derived before January 1, 1984 would be exempt from tax. This result is achieved by treating such income as previously taxed income.

To alleviate the hardship that may result from deemed distributions to a shareholder of a DISC that would otherwise be recognized in income in a later year by the shareholder, a special rule provides for a spread of such income over four years. Deemed distributions from a DISC attributable to income derived by the DISC in the taxable year of the DISC which begins in 1983 after the date in 1983 on which the taxable year of the shareholder begins would be treated as received by the shareholder in four equal installments; the installments would be treated as received on the last day of each of the four taxable years of the shareholder which begins after the shareholder's taxable year beginning in 1983.

For example, a DISC's taxable year ends January 31 and the corporate shareholder of the DISC is a calendar year taxpayer. In 1983, the corporate shareholder would include in income the deemed distributions from the DISC for the DISC's year ending on January 31, 1983 and, under the bill (absent the four-year spread), the deemed distributions for the 11-month taxable year ending on December 31, 1983. Almost two years of deemed distributions would be includible in income in 1983. Under the bill, the deemed distributions for the 11-month period ending December 31, 1983, would be spread over a four-year period and includible in the income of the shareholder in 4 equal installments: on December 31 of 1983, 1984, 1985, and 1986.

Transfers from DISC to FSC

Except to the extent provided in regulations to be prescribed, section 367 (which taxes some transfers of appreciated assets to foreign corporations) would not apply to transfers made generally before January 1985 to a FSC of qualified export assets held on August 4, 1983, by a DISC in a transaction to which section 351 or 368(a)(1) apply.

Effective date

The provisions of the bill would generally apply to transactions after December 31, 1983, in taxable years ending after such date. The provisions relating to treatment of trade receivables would apply to accounts receivable and evidences of indebtedness acquired by the foreign corporation after August 4, 1983 (the date of introduction).

IV. ECONOMIC ANALYSIS OF S. 1804

When the DISC legislation was adopted in 1971, the U.S. merchandise trade balance was in deficit for the first time since the Second World War. Despite enactment of the DISC legislation, the merchandise trade deficit is larger than it was in 1971, and continues to be an important issue of Congressional concern. There has been considerable controversy over the extent to which DISC has actually stimulated exports and whether the associated revenue loss is justified. In this section, the effectiveness of the DISC legislation is analyzed and compared with the substitute foreign sales corporation (FSC) proposal as introduced in S. 1804 and H.R. 3810.

Effectiveness of DISC

The DISC legislation provides an indefinite deferral of tax on a portion of qualified export income which is allocated to a DISC. This effectively reduces the rate of tax on the income from capital used in the production of exports distributed through DISCs. To the extent that the tax benefit is passed through to foreign customers (as a lower dollar price) and the exchange rate is fixed, DISCs increase the competitiveness of U.S. exports. The primary rationale for enacting the DISC legislation was to stimulate exports, and, thereby, the economy and employment, and also to remove a perceived tax disadvantage of domestic exporters. Congress was concerned that tax incentives provided by other countries gave foreign producers, including U.S.-controlled foreign subsidiaries, an advantage over domestic producers, and created a tax incentive for U.S. companies to manufacture offshore.[39]

The Revenue Act of 1971 includes a requirement that the Secretary of the Treasury submit an annual report to Congress analyzing the operation and effect of the DISC provisions. Table 1 summarizes the revenue and export effects of the DISC legislation presented in the annual DISC Reports from 1972 through 1981. According to the Treasury Reports, the increase in merchandise exports attributable to the DISC legislation amounts to 3-4 percent of total U.S. merchandise exports. The revenue cost of the DISC program grew to an estimated $1.65 billion in 1981. The revenue cost per $100 of export increase was estimated to average $40 in 1973-1976 and $20 in 1977-1981. Table 1 also shows that the merchandise trade deficit was four times larger in 1981 than it was in 1972, the first year of DISC operation. These trade deficits are the result of a combination of factors including: the rapid rise in the world market price of petroleum, the 1980 grain embargo, and the conduct of macroeconomic policy both in the United States and abroad.

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[39] H. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971).

Table 1.—DISC Report Estimates: 1972-1981

[Dollar amounts in millions]

DISC year	DISC export increase		DISC revenue cost		Merchandise trade balance
	Amount	Percent of total exports	Amount	Percent of export increase	
1972	NA	NA	$35	NA	−$6,416
1973	$2,180	3.1	730	33	911
1974	2,900	2.9	1,120	39	−5,343
1975	2,380	2.2	1,150	48	9,047
1976	2,860	2.5	1,220	43	−9,306
1977	3,900	3.2	750	19	−30,873
1978	3,640	2.6	730	20	−33,759
1979	4,500-7,000	2.4-3.8	990	14-22	−27,846
1980	6,200-9,400	2.8-4.2	1,410	15-23	−25,338
1981	7,200-11,000	3.0-4.7	1,650	15-23	−27,889

Sources: Department of the Treasury, 1972-81 DISC Reports; Council of Economic Advisors, *Economic Report of the President* (1983).

The Treasury estimates of the cost effectiveness of DISC have been criticized in a study by Price Waterhouse.[40] The Price Waterhouse study concludes that the DISC legislation is a self-financing tax cut, that is, a tax cut which raises revenue. Unlike the Treasury Report, the Price Waterhouse study assumes that the additional exports attributable to DISC do not draw productive resources such as labor and capital from other sectors of the U.S. economy. Rather, the Price Waterhouse study adopts the position that the DISC export increase represents a net addition to GNP which generates new tax revenues (to the extent that tax on this income is not deferred). The Price Waterhouse position is most likely to be accurate when the economy is in a recession and there are idle resources.

Some economists have criticized the DISC program on the grounds that it is inefficient and does not necessarily increase U.S. employment.[41] They point out that the fixed exchange rate system was replaced by a flexible rate system shortly after the DISC program was enacted. Under the current system of floating exchange rates, export incentives are rendered ineffective, to some extent, by appreciation of the dollar. Such appreciation reduces the dollar price of imports and raises the foreign currency price of exports.

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[40] Price Waterhouse, *Economic Impacts of the Domestic International Sales Corporation (DISC) Tax Provisions*, A study prepared for the American Business Conference, *et. al.*, (April 15, 1982).

[41] *See* J.G. Gravelle and D.W. Kiefer, *Deferral and DISC: Two Targets of Tax Reform*, Congressional Research Service (February 3, 1978) and D.L. Brumbaugh, *DISC: Effects, Issues and Proposed Replacements*, Congressional Research Service (April 5, 1983).

Thus there may be an expansion of employment in the export sectors, and a decline in employment in import-competing sectors such as the automobile industry. Due to adjustments in the exchange rate over time, export incentives may fail to have a sustained impact on *net* U.S. exports or employment. For this reason, some economists have argued that a change in macroeconomic policy to reduce the high value of the dollar is a better method of resolving the trade deficit than import barriers or export incentives.

In addition to any direct revenue costs associated with the DISC legislation, there may be a hidden efficiency cost to the U.S. economy.[42] This efficiency loss is attributable to the misallocation of resources between export and non-export sectors of the economy. U.S. income may decline both because resources are not deployed in the sectors where their productivity is highest, and because the dollar appreciation which may result from the operation of the DISC legislation reduces income from offshore investments.[43]

Some economists fault the design of the DISC program on the ground that it is inadequately targeted. They argue that exports are unlikely to increase in sectors where DISC tax benefits are not passed forward as lower prices but are instead passed back to shareholders as higher profits.[44] The more difficult it is for firms to enter an industry, the less likely it is that competitive market forces will ensure that DISC benefits result in lower export prices. On these grounds, some have argued that the Export-Import Bank is a more effective program than DISC since the benefits it provides go primarily to the more competitive export sectors.

Another frequent criticism of the DISC legislation is that the benefits are heavily concentrated in the hands of a small number of exporters. According to the 1981 Treasury Report, 35.2 percent of the tax benefit of the DISC program went to 26 DISCs, or 0.3 percent of the total 8665 DISCs in that year. Almost half of the tax benefit (49 percent) went to 89 DISCs, or 1 percent of the total. The main reason for this concentration of DISC benefits is that a few firms account for a large share of total exports. Indeed, the 1981 Report indicates that, per dollar of export income, small DISCs receive more tax savings than large DISCs. This shows the effect of the incremental provisions which, since 1976, have limited deferral to the excess of current period over base period DISC income; DISCs with $100,000 of income or less are exempted from these provisions.

When the DISC legislation was adopted in 1971, Congress was concerned that tax incentives provided by other countries gave foreign manufacturers an advantage over U.S. firms. However, over the last 10 years, there have been numerous changes in the U.S. corporate tax, including: restoration of the investment credit in 1971, liberalization of the investment credit in 1975, reduction of the corporate tax rate from 48 to 46 percent in 1979, and acceleration of depreciation allowances with the introduction of the accelerated capital recovery system (ACRS) in 1981. Since the U.S. investment credit and ACRS depreciation are generally available only on domestic capital, the tax disadvantage of manufacturing in the United States may have declined, if not reversed, since the enactment of the DISC legislation.

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[42] J. Mutti and H. Grubert, *DISC and its Effects*, National Bureau of Economic Research Summer Institute on International Studies (December 1982).

[43] Foreign asset holdings of U.S. investors yield foreign currency income. When the dollar appreciates, the value of this foreign investment income drops in dollar terms.

[44] *See* T. Horst and T. Pugel, "The Impact of DISC on the Prices and Profitability of U.S. Exports," *J. of Public Economics*, Vol. 7, 73-87 (1977).

The GATT permits member countries to exempt (or rebate) direct taxes, such as value added taxes, on exported items; but GATT prohibits the exemption (or rebate) of direct taxes, such as corporate income and payroll taxes.[45] Critics of the GATT rules have argued that DISC is necessary to offset the disadvantage U.S. exporters confront as a result of the fact that the United States relies relatively more on direct taxes than its trading partners. However, the difference in relative tax burdens on U.S. and foreign goods is generally due to differences in direct rather than indirect taxes. U.S. exports and locally produced foreign goods are both free of U.S. indirect taxes (e.g., state and local sales taxes), and subject to foreign indirect taxes (e.g., value added taxes) in the country where the goods are used. Similarly, imports and domestically produced goods consumed in the United States are both free of foreign indirect taxes and subject to U.S. indirect taxes. Thus, in general, if U.S. goods have a tax disadvantage in the world market, this results from higher direct taxes (e.g., payroll, property, and income taxes) in the United States compared to our trading partners.

Economic Comparison of FSC and DISC

In a territorial tax system, a nation does not assert the right to tax income attributable to economic activities that take place outside the nation's borders; such income is exempt from the nation's tax. In December 1981, the GATT Council adopted the position that territorial taxation does not constitute an export subsidy provided that arm's-length pricing rules are used to distribute income between a firm and its foreign branches and subsidiaries. The GATT Council did not at that time resolve the longstanding allegation of certain countries that DISC is an illegal export subsidy. In March 1983, the Administration proposed to replace DISC with a new tax system for exports—FSC. Under the FSC proposal, domestic firms which export through an FSC would be exempt from U.S. tax on a portion of the export income attributable to the FSC.

Table 2 shows the computation of U.S. tax for a small DISC, a "typical" DISC, and a FSC. In each case it is assumed that the parent corporation, in conjunction with its DISC or FSC, has $100 of combined gross receipts, $80 of total deductions, and $20 of combined taxable income. In the DISC examples, the $20 of combined taxable income is allocated half ($10) to the parent and half to the DISC.[46] In the small DISC case (less than $100,000 of DISC taxable income), 42.5 percent (i.e., 50 percent less the 15 percent cutback enacted in the Tax Equity and Fiscal Responsibility Act of 1982) of

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[45] Although there is some ambiguity, direct taxes are generally defined to include: corporate and personal income, payroll, property, wealth, gift, estate, and other taxes which are imposed on the individual (or entity) that is meant to bear the burden. Indirect taxes are generally defined to include: sales, value added, excise, and other specific taxes which are imposed at one level of production or distribution but are meant to be shifted forward to the ultimate consumer.

[46] Under these facts, the 50 percent of combined taxable income allocation method results in less tax than either the 4 percent of gross receipts method or the arm's-length method.

DISC taxable income is deferred from taxation, and 57.5 percent ($5.75) is deemed distributed to the parent. Total taxable income is equal to the parent's allocated income ($10) plus the deemed distribution ($5.75), or $15.75. Thus for a company with a small DISC, tax liability is $7.25 (.46 x $15.75), and the effective tax rate on export income is 36.2 percent ($7.25/$20).[47]

Table 2.—Comparison of Export Income Taxation Under DISC and the FSC Proposal

Item	Small DISC	Typical DISC	Proposed FSC
1. *Combined account:*			
Gross export receipts	$100.00	$100.00	$100.00
Total deductions	80.00	80.00	80.00
Combined taxable income	20.00	20.00	20.00
2. *FSC account:*			
Gross FSC receipts	NA	NA	100.00
Total deductions	NA	NA	95.40
Acquisition cost (transfer price)	NA	NA	94.40
Other FSC costs	NA	NA	1.00
FSC net income	NA	NA	4.60
Exempt income	NA	NA	3.40
Effectively connected income	NA	NA	1.20
3. *DISC account:*			
DISC taxable income	10.00	10.00	NA
DISC deferred income	4.25	3.40	NA
Deemed distribution	5.75	6.60	NA
4. *Parent account:*			
Gross receipts	100.00	100.00	94.40
Total deductions	80.00	80.00	79.00
Net income before allocation	20.00	20.00	15.40
Total taxable income	15.75	16.60	16.60
Net income after allocation	10.00	10.00	15.40
FSC effectively connected income	NA	NA	1.20
DISC deemed distribution	5.75	6.60	NA
U.S. tax	7.25	7.64	7.64
Effective U.S. tax rate (percent)	36.2	38.2	38.2

The deferral rate for a "typical" DISC is lower than for a small DISC since deferral is limited to 42.5 percent of the excess of current DISC taxable income over base period income. A typical DISC, according to Treasury data, has a deferral rate of 34 percent, so that $3.40 is deferred from tax, and $6.60 is deemed distributed to the parent. Total taxable income is equal to the parent's allocated income ($10) plus the deemed distribution ($6.60), or $16.60. Thus for a company with a typical DISC, tax liability is $7.64 (.46 x $16.60), and the effective tax rate on export income is 38.2 percent ($7.64/$20).

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[47] In this example it is assumed that there are no credits and that tax depreciation equals economic depreciation.

The computation of tax for a parent selling through a FSC is shown in the third column of Table 2. In this example it is assumed that the FSC is incorporated in a jurisdiction which imposes negligible tax on the income allocated to the FSC. It is also assumed that the FSC performs certain economic activities such as sales promotion and arranging for transportation so that the $100 of export receipts qualifies as foreign trading gross receipts under the proposal. The cost of conducting these economic activities in the FSC accounts for $1 of the total $80 cost of sales and operations.

Under the proposal, one of two methods of apportionment (in addition to the arm's-length method) may be used to determine the FSC's share of the $20 of combined taxable income: (1) 23 percent of combined taxable income, and (2) 1.83 percent of gross receipts. In this example, the income method results in the largest apportionment of income to the FSC: $4.60 (.23 x $20). Hence, the transfer price from the parent to the FSC is established as $94.40 ($100-$1-$4.60) since this is the price which results in exactly $4.60 of foreign trading income. The remaining $15.40 ($20-$4.60) is allocated to the parent company and is subject to U.S. tax. According to the proposal, a portion (17/23) of the FSC's income is exempt from U.S. tax, and the remaining portion (6/23) is "effectively connected" income which is subject to U.S. tax. Total taxable income is equal to the parent's allocated income ($15.40) plus the effectively connected income ($1.20), or $16.60. Thus for a company with a FSC, tax liability is $7.64 (.46 x $16.60), and the effective tax rate on export income is 38.2 percent ($7.64/$20).

Table 2 (which uses Treasury assumptions) shows that the effective U.S. tax rate on export income is 38.2 percent under the FSC proposal as well as for a company with a typical DISC. However, companies with small DISCs, which are exempt from the incremental rule, are taxed more lightly under current law at an effective rate of 36.2 percent. Under the incremental rule of current law, small, new, or rapidly growing DISCs enjoy a higher deferral rate and a lower effective tax rate than large, older, or slow growing DISCs. Since there are no incremental provisions in the FSC proposal, adoption of S. 1804 would tend to hurt small, new, and rapidly growing DISCs which have an above average deferral rate, and benefit large, older, and slow growing DISCs which have a below average deferral rate. Table 3 shows that the rapidly growing export sectors which might tend to be hurt by the FSC proposal include: chemicals, fabricated metal products, electrical machinery, and scientific instruments. The slow growing export sectors which would most likely benefit from the FSC proposal include: minerals, food, lumber, and leather products. (The minerals industry would also benefit because the FSC proposal would provide benefits to products on which depletion deductions are allowable, other than oil and gas related products. Thus, coal and uranium, which are excluded from DISC, would be eligible for FSC benefits.)

Table 3.—Growth Rate of DISC Exports by Sector

[Dollar amounts in billions]

Sector	1977 gross receipts	1981 gross receipts	Growth rate of gross receipts (percent)
Total	$82.681	$154.078	16.8
Nonmanufactured Products	23.997	42.517	15.4
Agriculture	22.512	40.401	15.7
Mineral products	.767	1.063	8.5
Other	.716	1.053	10.1
Manufactured Products	58.684	111.561	17.4
Ordnance and accessories	.225	.197	−3.3
Food and kindred products	3.154	4.204	7.4
Tobacco manufactures	.452	1.110	25.2
Textile mill products	.837	1.829	21.6
Apparel, etc	.171	.582	35.8
Lumber, etc. ex. furniture	2.093	2.884	8.3
Furniture and fixtures	.018	.081	45.6
Paper and allied products	1.458	3.115	20.9
Printing, publishing, etc	.209	.392	17.0
Chemicals & allied products	6.926	16.728	24.7
Rubber and misc. products	.565	1.085	17.7
Leather & leather products	.635	.837	7.1
Stone, clay, glass & cement	.445	.882	18.7
Primary metal	1.086	3.262	31.6
Fabricated metal products	1.860	4.264	23.0
Machinery, ex. electrical	13.214	22.549	14.3
Electrical machinery	6.118	14.360	23.8
Transportation equipment	15.161	21.796	9.5
Scientific instruments	2.804	6.027	21.1
All other manufacturing	1.254	2.379	17.4

Source: Department of the Treasury, 1977 and 1981 Annual DISC Reports.

Some have suggested that because the FSC proposal lacks an incremental rule, it is likely to be less cost-effective, in terms of revenue loss per dollar of additional exports, than the DISC program. However, it is not certain that the incremental rule has increased the long-run efficiency of the DISC program. First, under the incremental rule, an increase in exports yields tax-deferred income in the current year but reduces tax-deferred income in future years. This occurs because, after four years, the original increase in exports enters into base period gross receipts and decreases the amount of incremental DISC income eligible for deferral.[48] Second, for exporters with slow growing or declining sales, the incremental rule could reduce DISC benefits to the point where it is more advantageous to manufacture offshore than in the United States. For these reasons, the incremental rule, enacted in 1976, may have failed to increase the efficiency of the DISC program compared to a non-incremental system with the same revenue cost (e.g., the FSC proposal).

An important difference between DISC and the FSC substitute is that a FSC must be incorporated abroad and may be subject to foreign tax. Under the FSC proposal, the foreign taxes paid by a FSC would not be credited against U.S. tax liability. In addition, the FSC must maintain an office and a permanent set of books outside the United States and must engage in some of the economic activities related to the export receipts of the parent company. Only small FSCs (under $2.5 million of annual gross receipts) are exempted from the requirement of conducting significant offshore economic activities. The additional expenses (including any foreign taxes) associated with operating a FSC would reduce the net benefit from exporting through a FSC. Thus, for the same revenue loss, the FSC legislation may stimulate fewer additional exports than DISC since firms would only utilize a FSC if the tax savings cover the transaction costs of the offshore corporation.

Another important difference between DISC and the FSC substitute is that DISC provides a deferral of tax, rather than an exemption from tax. To qualify for tax deferral, the asset test requires that a DISC invest 95 percent of its accumulated deferred income in qualified export assets such as: export trade receivables, producer loans, inventory, and Export-Import Bank (Ex-Im) obligations. For many companies the restrictions on the use of these funds are not a significant burden. Receivables can be financed and the parent can obtain the current use of funds through producer loans. But to the extent that the accumulated tax-deferred income must be invested in Ex-Im obligations, which have a low yield and do not enable the parent corporation to use the funds in normal operations, the asset test imposes more of a burden. According to the 1981 DISC Report, 6 percent (i.e., $1.2 billion) of total DISC assets were invested in Ex-Im obligations. (Adoption of the FSC proposal would eliminate the captive market for low yield Ex-Im obligations and, consequently, reduce the ability of the Ex-Im Bank to finance exports.) For some companies, the asset test may become sufficiently onerous that there would no longer be an incentive to export through a DISC. Since the FSC proposal is an exemption system, there is no asset test. Thus FSC may be a more potent export incentive in cases where the asset test would have reduced DISC benefits.

Another important practical difference between DISC and the FSC substitute arises from elimination of the assets test and the gross receipts test. The consequences of failure of a DISC to meet these tests are severe; all previously deferred income may become taxable. In contrast, even if a FSC fails to meet the requirements to be a FSC, or to meet the economic process tests with respect to a transaction, no such harsh result follows; current benefits may be lost but not the benefits from prior years.

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[48] *See* Appendix C of the Treasury's 1976 DISC Report. There it is argued that if export receipts grow faster (slower) than the cost of capital, then the incremental rule makes DISC less (more) cost-effective than it would be without the incremental rule.

APPENDIX A:

SIDE-BY-COMPARISON OF DISC AND FSC PROVISIONS

Item	DISC	FSC
1. Entity subject to Federal income tax	No.	Yes (exclusion for exempt foreign trade income).
2. Type of entity	(a) A corporation which is incorporated under the laws of any State; (b) that has one class of stock, par or stated value of $2,500; (c) no restriction on number of shareholders; (d) no Board of Directors restriction.	(a) A corporation which is incorporated under the laws of a foreign country or U.S. possession; (b) that has no preferred stock; (c) that has no more than 25 shareholders; (d) that has at least one nonresident individual on Board of Directors.
3. Election	Yes.	Yes.
4. Taxable year	Need not conform to taxable year of shareholders.	Must conform to taxable year of majority shareholder.
5. Qualified export assets and gross receipts requirement	Yes. Failure to satisfy requirements results in taxation of previously deferred income and may result in termination of DISC.	No.
6. Foreign presence requirement	No.	Yes.
7. Excluded corporations	Generally not a tax-exempt corporation, personal holding company, financial institution, insurance company, regulated investment company, or S corporation.	Not a member of a controlled group which includes a DISC.
8. Type of income	95 percent must be qualified gross receipts.	Exclusion from income is limited to exempt foreign trade income.

SIDE-BY-COMPARISON OF DISC AND FSC PROVISIONS—Continued

Item	DISC	FSC
9. Export receipts	Qualified gross receipts are, generally gross receipts from the sale, lease or rental of export property and from related services; and certain dividends, interest, and gross receipts from qualified assets (other than export property).	Foreign trading gross receipts are generally the same as DISC qualified gross receipts; but do not include dividends, interest, and gross receipts from certain property that is not export property. To qualify foreign management and foreign economic process requirements must be met.
10. Excluded receipts	Generally not: (a) gross receipts for use in U.S. that is subsidized or used by the U.S. under law requiring such use; and (b) receipts from a related DISC.	(a) Same as DISC, and (b) receipts from a related FSC.
11. Export property	(a) Property manufactured, produced or grown in the U.S. for use or disposition outside the U.S.	(a) Same as DISC, and (b) fungible agricultural products sold through an exempt farmers' cooperative.
12. Excluded property	Generally not: property for use by a related corporation, intangibles, depletable products, property the export of which is prohibited, and property in short supply.	Same as DISC, except oil and gas are the only excluded depletable products (coal and uranium are not excluded).
13. Intercompany pricing rules	Transfer price based on: (a) 4 percent of qualified export receipts; (b) 50 percent of combined taxable income; or (c) sales price actually charged but subject to sec. 482.	Transfer price based on: (a) 1.83 percent of foreign trading gross receipts; (b) 23 percent of combined taxable income; or (c) same as in DISC. To use administrative pricing rules ((a) or (b) above) for a transaction, the FSC must perform certain activities with respect to the transaction.
14. Taxation of income to shareholders	DISC not subject to tax, but shareholders are subject to tax on certain deemed distributions and actual distributions out of deferred income.	FSC subject to tax. Corporate shareholder receives a 100 percent dividend-received deduction for dividends attributable to foreign trade income.

15. Disposition of stock	Gain recognized as a dividend to the extent of accumulated DISC income.	No similar provision needed because there is no deferred income.
16. Distributions	Treated as: (a) first out of previously taxed income; (b) second, out of accumulated DISC income; and (c) third, out of any other earnings and profits.	Treated as: (a) first out of earnings and profits attributable to foreign trade income; and (b) second, out of any other earnings and profits.
17. Maximum tax benefit	Deferral of tax on 1.7 percent of gross receipts or 21.25 percent of combined taxable income (subject to reduction by incremental rule).	Tax exemption on 1.35 percent of gross receipts or 17 percent of combined taxable income.
18. Small business	Exemption from incremental rule if taxable income is $100,000 or less; phaseout of exemption from incremental rule between $100,000 and $150,000.	(a) Interest-charge DISC (applicable to gross receipts of $10 million or less) essentially same as DISC, except—no incremental rule; no deemed distributions, and an interest charge is imposed on deferred income. (b) Small FSC exception for gross receipts of $2,500,000 or less from certain foreign presence and foreign economic activity requirements.

APPENDIX B:

SELECTED GATT DOCUMENTS

1. Article XVI of the General Agreement

Subsidies

SECTION A — SUBSIDIES IN GENERAL

1. If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the Contracting Parties [throughout this Appendix, the term "Contracting Parties," with initial capital letters, refers to the general membership of GATT] in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidization.

SECTION B—ADDITIONAL PROVISIONS ON EXPORT SUBSIDIES

2. The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement.

3. Accordingly contracting parties should seek to avoid the use of subsidies on the export of primary products. If, however, a contracting party grants directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory, such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product, account being taken of the shares of the contracting parties in such trade in the product during a previous representative period, and any special factors which may have affected or may be affecting such trade in the product.

4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any prod-

uct other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.

5. The Contracting Parties shall review the operation of the provisions of this Article from time to time with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of this Agreement and avoiding subsidization seriously prejudicial to the trade or interests of contracting parties.

2. Article XXIII of the General Agreement

Nullification or Impairment

1. If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of

(a) the failure of another contracting party to carry out its obligations under this Agreement, or

(b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or

(c) the existence of any other situation,

the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

2. If no satisfactory adjustment is effected between the contracting parties concerned within a reasonable time, or if the difficulty is of the type described in paragraph 1(c) of this Article, the matter may be referred to the Contracting Parties. The Contracting Parties shall promptly investigate any matter so referred to them and shall make appropriate recommendations to the contracting parties which they consider to be concerned, or give a ruling on the matter, as appropriate. The Contracting Parties may consult with contracting parties, with the Economic and Social Council of the United Nations and with any appropriate inter-governmental organization in cases where they consider such consultation necessary.

If the Contracting Parties consider that the circumstances are serious enough to justify such action, they may authorize a contracting party or parties to suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate in the circumstances. If the application to any contracting party of any concession or other obligation is in fact suspended, that contracting party shall then be free, not later than sixty days after such action is taken, to give written notice to the Executive Secretary to the Contracting Parties of its intention to withdraw from this Agreement and such withdrawal shall take effect upon the sixtieth day following the day on which such notice is received by him.

3. Report of the GATT Panel on DISC: Conclusions [49]

67. The Panel started by examining the effects of the DISC legislation in economic terms. The Panel concluded that it conferred a tax benefit and that this benefit was essentially related to exports. The Panel considered that if the corporation income tax was reduced with respect to export related activities and was unchanged with respect to domestic activities for the internal market this would tend to lead to an expansion of export activity. Therefore, the DISC would result in more resources being attracted to export activities than would have occurred in the absence of such benefits for exports.

68. The Panel noted that the United States Treasury had acknowledged that exports had increased as a result of the DISC legislation and the Panel considered that the fact that so many DISCs had been created was evidence that DISC status conferred a substantial benefit.

69. The Panel noted that the DISC legislation was intended, in its own terms, to increase United States exports and concluded that, as its benefits arose as a function of profits from exports, it should be regarded as an export subsidy.

70. The Panel examined whether a deferral of tax was "a remission" in terms of item (c) or "an exemption" in terms of item (d) of the illustrative list of 1960 (BISD, 9 Suppl. p. 186).

71. The Panel was not convinced that a deferral, *simply* because it is given for an indeterminate period, was equal to a remission or an exemption. In addition it noted that the DISC legislation provided for the termination of the deferral under specified circumstances. The Panel further noted, however, that the deferral did not attract the interest component of the tax normally levied for late or deferred payment and therefore concluded that, to this extent, the DISC legislation constituted a partial exemption which was covered by one or both of paragraphs (c) and (d) of the illustrative list.

72. The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel further noted that these contracting parties considered that, in general, the practices contained in the illustrative list could be presumed to result in bi-level pricing, and considered that this presumption could therefore be applied to the DISC legislation. The Panel concluded, however, from the words "generally to be considered" that these contracting parties did not consider that the presumption was absolute.

73. The Panel considered that, from an economic point of view there was a presumption that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort and (c) in-

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[49] This is an excerpt from GATT Doc. L/4422 (Nov. 2, 1976). The Panel's conclusions began with paragraph 67; the preceding 66 paragraphs set forth background information and the arguments of the parties.

crease of profits per unit. Because the subsidy was both significant and broadly based it was to be expected that all of these effects would occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel did not accept that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. These conclusions were supported by statements by American personalities and companies and the Panel felt that it should pay some regard to this evidence.

74. The Panel therefore concluded that the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4.

75. The Panel examined the significance of the various options under the DISC legislation for the allocation of profits from export sales between parent companies and DISCs, and concluded that these could influence the size of the exemption.

76. The Panel concluded that the provision allowing the deduction of certain shipping costs by DISCs (on the condition that exports be carried in United States vessels), and the provision allowing 10 percent of export promotion expenses to be assigned as a deductible expense to a DISC would appear to confer additional pecuniary benefits.

77. The Panel considered that, as it had found the DISC legislation to constitute an export subsidy which had lead to an increase in exports, it was also covered by the notification obligation contained in Article XVI:1.

78. While the Panel noted that primary product exports were eligible for DISC benefits and had been traded substantially through DISCs, it did not examine whether the benefits would result in the United States obtaining a disproportionate share of the world market in terms of Article XVI:3.

79. The Panel noted the United States argument that it had introduced the DISC legislation to correct an existing distortion created by tax practices of certain other contracting parties. However, the Panel did not accept that one distortion could be justified by the existence of another one and considered that, if the United States had considered that other contracting parties were violating the General Agreement, it could have had recourse to the remedies which the General Agreement offered. On the other hand, the fact that tax practices of certain other countries had been in force for some time without being the subject of complaints was not, in itself, conclusive evidence that there was a consensus that they were compatible with the General Agreement.

80. In the light of the above and bearing in mind the precedent set by the Uruguayan case (BISD, 11 Suppl. p. 100),[50] the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.

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[50] That case stands for the proposition that where there is a clear infringement of the provisions of the General Agreement, or in other words, where measures are applied in conflict with the provisions of GATT, there is prima facie nullifacation or impairment of benefits.

4. Report of the GATT Panel on French Tax Practices: Conclusions (Excerpts) [51]

"The Panel noted that the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries."

"The Panel found that however much the practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context."

"The Panel also noted that the tax treatment of dividends form abroad [taxation at a nominal rate] ensured that the benefits referred to above were fully preserved."

". . . [T]he Panel concluded that there was a partial exemption from direct taxes. The Panel further concluded that the practices were covered by one or both items (c) and (d) of the illustrative list of 1960 (BISD, 9 Suppl. p. 186)."

"The Panel added that bi-level pricing had probably occurred. . . , [and] concluded that the French tax practices in some cases had effects which were not in accordance with French obligations under Article XVI:4."

"The Panel noted that the allocation of profits between companies and their foreign operations was made in accordance with the arm's-length pricing principle but that there were formal exceptions[52] to this principle and concluded that the benefit would be increased to the extent that arm's-length pricing was not fully observed."

"The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in French exports in some sectors and although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1."

"The Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement."

5. 1979 Subsidies Code—Footnote 2 to Item (e)

In adopting the Subsidies Code in 1979, the GATT signatories included the following footnote to explain Item (e) of the Illustrative

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[51] This is a series of excerpts from "Income Tax Practices Maintained by France," GATT Doc. No. L/4423 (Nov. 2, 1976).

[52] Notes of the French Administration in 1959 and thereafter had indicated that the French authorities did not apply arm's-length pricing rules strictly to export transactions (Panel report at paragraph 26).

List of export subsidies, which lists exemption, remission or deferral, specifically related to exports, of direct taxes:

"The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the Contracting Parties of the specific issues raised in GATT document L/4422 [the DISC case].

The signatories reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence.

"Paragraph (e) is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises or the enterprises of another signatory.

"Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time. . . ."

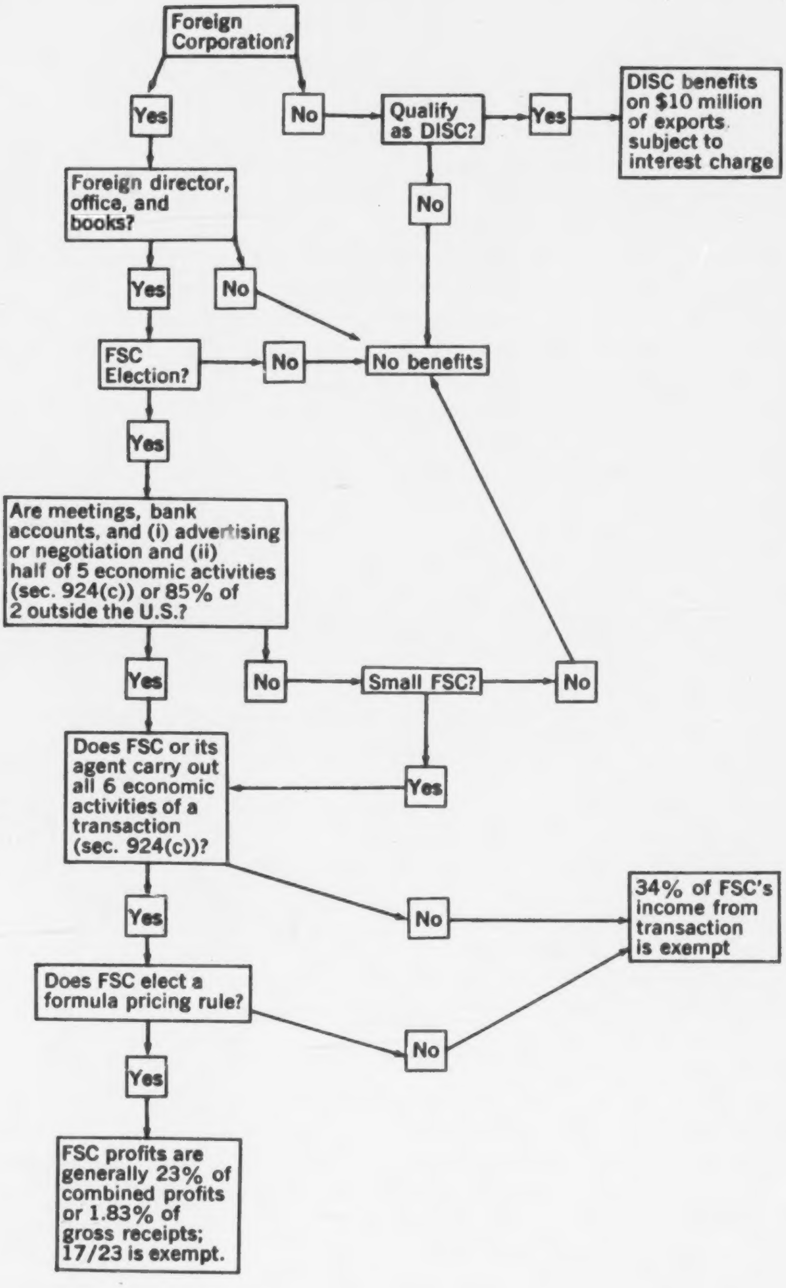
At a meeting in December, 1981, the GATT Council adopted all four panel reports governing the tax practices of Belgium, France, the Netherlands, and the United States, but with a qualification. The text of the agreement is reproduced herein.

6. GATT Council Adoption of Panel Reports

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

APPENDIX C

FLOW CHART: QUALIFICATION FOR BENEFITS UNDER S. 1804


Foreign Corporation?
Yes
No
Qualify as DISC?
Yes
DISC benefits on $10 million of exports subject to interest charge
No
Foreign director, office, and books?
Yes
No
FSC Election?
No
No benefits
Yes
Are meetings, bank accounts, and (i) advertising or negotiation and (ii) half of 5 economic activities (sec. 924(c)) or 85% of 2 outside the U.S.?
Yes
No
Small FSC?
No
Yes
Does FSC or its agent carry out all 6 economic activities of a transaction (sec. 924(c))?
Yes
No
34% of FSC's income from transaction is exempt
Does FSC elect a formula pricing rule?
No
Yes
FSC profits are generally 23% of combined profits or 1.83% of gross receipts; 17/23 is exempt.

Senator DANFORTH. Is either the Governor of the Virgin Islands or the Lieutenant Governor of the Virgin Islands with us this morning?

Lieutenant Governor BRADY. Yes, sir.

Senator DANFORTH. And Congressman de Lugo is also here?

Mr. DE LUGO. Yes, Senator.

Senator DANFORTH. Congressman, how are you?

Mr. DE LUGO. It's good to see you, Senator.

Senator DANFORTH. It's good to see you.

Mr. DE LUGO. Mr. Chairman, I would just take one moment then I would like to introduce our Lieutenant Governor. But before I do, I would like to say for the record that, while I realize that a need to respond to the GATT objections to domestic international corporations may be viewed as inconvenient by some exporters, I am pleased that the resolution proposed by S. 1804 includes the opportunity for the U.S. Virgin Islands to host the new foreign sales corporations. I believe exporters will find doing business through the U.S. Virgin Islands a happy consequence.

Now I would like to introduce the distinguished Lieutenant Governor of the Virgin Islands, Julio Brady, who is here to support this legislation on behalf of Gov. Juan Luis.

Senator DANFORTH. Congressman, thank you very much.

Governor, good to have you here.

Lieutenant Governor BRADY. Thank you, Senator.

STATEMENT OF HON. JULIO BRADY, LIEUTENANT GOVERNOR OF THE U.S. VIRGIN ISLANDS

Lieutenant Governor BRADY. Good morning.

Very, very quickly—I know you are pressed for time—we wanted to appear here to demonstrate and to make very clear to this committee and to Congress that we are fully in support of this legislation. We feel that it advances not only the best economic interests of the country and the administration but also the territories. And the cornerstone of the administration's policy toward the territories has been urging us to become more economically self-sufficient. And in order to do that, we must expand, essentially, our revenue base. And this legislation offers us a perfect opportunity to do that.

The Virgin Islands, as you know, is a fairly mature community in terms of commercial ventures, and we do have a large banking industry and insurance industry already.

As Lieutenant Governor, by the way, I have direct authority over the regulation of the insurance industry, so it is particularly appropriate that I come here and testify; because we are determined to utilize this opportunity.

We have the infrastructure already in place. As I said, we have the banks, we have telecommunications, we have convenient air service and all of the other infrastructure needs that would be required to support the type of activity that this bill would require of the companies.

So we are not talking about dummy or paper corporations; we are talking about real businesses that will employ real people and have an actual effect on our economy and our development.

So for those reasons we have urged and continue to urge the passage of this legislation.

In passing, I might also mention that the Governor has personally met with representatives of the industry who would be most likely to take advantage of these provisions, and we have assured them, the ECAT, the Emergency Committee for American Trade, that we would be willing to make whatever accommodations are reasonably necessary in order to promote this industry.

Just one word of caution. I understand there is some concern that jurisdictions that do not cooperate, so to speak, with our government in terms of exchange of information to insure that taxes are fully paid. We are not one of those jurisdictions, of course, and we would actually like to recommend that you limit the availability of this type of benefit to those jurisdictions that have favorable exchange-of-information provisions—tax exchange of information provisions with the United States.

So, with that small proviso, we fully are in support of this; we would urge you to consider it as a thing that is good for our country and good for your fellow Americans in our West Indian Territory.

That's all I have to say, Senator.

Senator DANFORTH. Governor, thank you very much. I take it this is a signficant matter as far as the Virgin Islands is concerned?

Lieutenant Governor BRADY. Very much so, Senator.

Senator DANFORTH. And you view it as a very promising thing for your economy; is that right?

Lieutenant Governor BRADY. Indeed. I think it is a golden opportunity to advance, as I say, the goals of the administration and our own self-interest.

Senator DANFORTH. What sort of tax treatment would you expect foreign sales corporations to get in the Virgin Islands?

Lieutenant Governor BRADY. That, of course, would be a matter to determine on a policy basis, but we have as a matter of territorial policy now a structure called the industrial incentive program, and we encourage businesses and industries to move there. They are usually involved in manufacturing, and so forth, but the same principle would apply here. We would go as far as we had to go—without, of course, denying ourselves the appropriate benefits—to make the establishment of these industries in the territory profitable to the industries and to the government. So we probably would be generous in our tax provisions toward them.

Senator DANFORTH. Good.

Governor, thank you very much for being with us this morning.

Lieutenant Governor BRADY. Thank you very much, Senator, for your indulgence.

Senator DANFORTH. Next we have a panel: Evan Werling, French Oil Mill Machinery Co.; Glenn White, Dow Chemical Co.; Michael Fayhee, McDermott Will & Emery, Chicago; and Ron Joranko, TRW.

Mr. Werling.

Mr. WERLING. Yes. Right here, Senator.

[Gov. Juan Luis' prepared statement follows:]

STATEMENT OF
HONORABLE JUAN LUIS, GOVERNOR
UNITED STATES VIRGIN ISLANDS

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

REGARDING S. 1804
THE FOREIGN SALES CORPORATION ACT OF 1983

November 18, 1983

Mr. Chairman, distinguished members of this committee, it is indeed a pleasure to appear before you to affirm the U.S. Virgin Islands' support for S. 1804, the Foreign Sales Corporation Act of 1983.

S. 1804 would amend U.S. tax law to require U.S. exporters to establish "foreign sales corporations" (FSCs) in order to obtain certain tax benefits. FSCs would be required to undertake certain economic activities outside the United States Customs Zone. These activities include maintaining an office outside the zone, maintaining books and records in that office, and having at least one foreign director resident outside the U.S. Other significant business activities that could be performed outside the U.S. Customs Zone include soliciting orders and negotiating contracts, processing orders, and billing customers and receiving payments.

The U.S. Virgin Islands, although an insular possession of the United States, is outside the U.S. Customs Zone. I am pleased to note that S. 1804 specifically provides that the U.S. Virgin Islands is an eligible situs for foreign sales corporations.

We believe that U.S. companies planning to establish foreign sales corporations under the proposed legislation will find the Virgin Islands and its work force well suited to their needs. For example, in order to diversify our economy the Territory has already undertaken a program of economic expansion into the light manufacturing and service industries. Thus, a very large portion of our work force is already trained and experienced, possessing the types of clerical skills which foreign sales corporations would utilize.

Furthermore, the Territory is already equipped with the infrastructure FSCs would require, including frequent and convenient air service to the U.S. mainland, telecommunication links with the entire world, available office space, and an experienced professional community. Finally, pursuant to authority granted by S. 1804, the Virgin Islands would adopt tax relief measures that would make the Territory fully competitive with any low-tax jurisdiction.

Mr. Chairman, concern has arisen that S. 1804 might encourage the use of tax haven jurisdictions which do not cooperate in providing information to assist with the administration of U.S. tax laws. Indeed, S. 1804, as presently drafted, provides no restrictions on the types of jurisdictions in which FSCs may be established. Thus there is a very real possibility that tax haven jurisdictions could benefit from this legislation to the detriment of U.S. tax administration. In order to avoid such a result, the Virgin Islands would favor a provision which would limit eligible foreign jurisdictions to those which have in effect a tax exchange of information agreement with the United States.

Mr. Chairman, early this year when the administration was still developing its FSC proposal, I held meetings both with the office of the U.S. Trade Representative and with representatives of some of the major companies that are most likely to establish FSCs. I made it clear that the Virgin Islands is extremely enthusiastic about the FSC proposal and that we have both the capability and the desire to host the off-shore economic activities of FSCs within the familiar surroundings of the U.S. legal system and under the U.S. flag. To the companies that might establish FSCs I pledged that the Virgin Islands would work closely with them in developing and approving any needed changes in local law and in helping them establish operations in the Territory. To the federal administration I pledged my active support of the legislation. I am pleased to reaffirm those pledges today.

Mr. Chairman, while S. 1804 is primarily designed to fulfill our obligations to our major trading partners, it is also fully consistent with the U.S. policy toward its Territories, that is, to provide the Territories with the economic opportunities that they need in order to become financially self-sustaining. Mr. Chairman, S. 1804 would provide us with one such opportunity and we are most eager to pursue it. I strongly urge that the Finance Committee act favorably on the bill.

Thank you.

STATEMENT OF EVAN A. WERLING, VICE PRESIDENT, FINANCE, FRENCH OIL MILL MACHINERY CO., PIQUA, OHIO, ON BEHALF OF CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D.C.

Mr. **Werling.** I am Evan Werling, vice president of a small, family-owned agricultural equipment manufacturing company called the French Oil Mill Machinery Co. in Piqua, Ohio. We export approximately 50 percent of the products we manufacture, and export on a worldwide basis.

I am here representing the Chamber of Commerce of the United States today as a member of the Taxation Committee, and I am also a member of the Small Business Council. I am accompanied by Rachelle Bernstein, senior tax attorney for the chamber.

We welcome the opportunity to testify in support of S. 1804 today, however we believe there are certain changes that should be made in the legislation prior to its enactment.

First of all, we believe the factoring provisions should be removed from the legislation, since it is not related to legislation designed to amend the DISC to comply with GATT regulations.

Second, the bill contains two exceptions from the general FSC rules for small business. The first, the interest charge DISC, could result in a very substantial economic loss for many small businesses. The second, the small FSC provision, should be expanded to include more small businesses and provide a transition period during which small businesses can develop their offshore capabilities, recognizing the fact that few small businesses have that capability today.

Senator **Danforth.** Thank you very much, sir.

Mr. White.

[Mr. Werling's prepared statement follows:]

STATEMENT
on
THE FOREIGN SALES CORPORATION ACT OF 1983 (S. 1804)
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Evan A. Werling
November 18, 1983

I am Evan Werling, the Vice President of Finance for the French Oil Mill Machinery Company and a member of the Taxation Committee and Export Task Force of the Small Business Council of the United States Chamber of Commerce. Accompanying me today is Rachelle Bernstein, Senior Tax Attorney for the Chamber.

On behalf of the Chamber of Commerce of the United States, we welcome the opportunity to testify in support of S. 1804, which would amend the present rules for the Domestic International Sales Corporation (DISC) in order to meet the concerns of certain signatories to the General Agreement on Tariffs and Trade (GATT). However, we believe certain changes must be made in the legislation before it is enacted.

French Oil Mill Machinery Company is located in Piqua, Ohio, a community of approximately 20,000 people. French Oil is a small family-owned company (employing approximately 190 people) which exports on a worldwide basis approximately 50 percent of its sales volume. Our company designs and manufactures machinery used in the extraction of edible vegetable oils (such as soybean oil, corn oil, sunflower oil, etc.), separation of water from sugar cane, dewatering of natural rubber and synthetic polymers as well as in the molding of rubber into various products, from tennis balls to automotive engine gaskets.

SUMMARY

DISC was conceived to compensate for aspects of the U.S. income tax law which negatively impacted on U.S. exporters. Enacted in 1971, DISC was expected to remove the competitive disadvantage suffered by U.S. exporters as a result of the 1962 enactment of Subpart F of the Internal Revenue Code and uncertain administration and application of transfer pricing rules under section 482 of the Code, as well as to offset the tax advantages enjoyed by exporters in other countries.

The DISC is a U.S. corporation, income of which is derived substantially from the export of U.S. goods. The DISC is not taxed but rather 57-1/2 percent of the DISC's income is considered to be distributed to the DISC's shareholders who are taxed on that income. The remainder of the DISC's income is deferred until it is distributed to the shareholders, the shareholder sells his stock, or the corporation no longer qualifies as a DISC. Deferred DISC income is used to finance U.S. exports.

At the October, 1982 meeting of the GATT Council, U.S. Trade Representative William Brock announced that the Administration would propose an alternative to DISC because of complaints made by members of the Council that the DISC violates GATT.

The Chamber of Commerce of the United States strongly supports the concept of the DISC and opposes any elimination of its benefits. If a substitute for DISC is needed to meet GATT concerns, the substitute should not reduce any of the benefits presently received by DISC users. The problems in the U.S. tax law which led to the enactment of DISC are still present today. DISC is essential to U.S. businesses because it makes major inroads in offsetting the disadvantage which U.S. business suffers vis-a-vis their trading partners who have the benefit of taxation systems more favorable to exporting.

In defining the parameters of the DISC alternative, the Administration expressed its desire to maintain present exporter use of a DISC-like entity and merely arrange the structure of this entity to comply with GATT. They specifically stated that the substitute was to be GATT-legal, avoid any tax increases for exporters, be revenue neutral, and be usable by small business. We believe that S.1804 accomplishes this goal with two exceptions: (1) the provisions for small business must be modified to assure that small business can use the new proposal, and (2) the provisions relating to the taxation of income from trade receivables of related persons add a new tax increase.

TAXATION OF THE FOREIGN SALES CORPORATION

S. 1804 would replace the DISC with a Foreign Sales Corporation (FSC). Under the proposal, export sales would be made through a FSC in a manner similar to the way they are presently made through a DISC. However, the FSC would be incorporated outside the United States, and certain activities related to the export sales made by the FSC would have to be performed outside the United States in order to meet GATT rules requiring that tax exempt income be from economic processes occurring outside the United States.

Under the proposal, a portion of the FSC's income would be exempt from U.S. tax at both the corporate and domestic shareholder levels. The income from the FSC would be determined by using an arm's length pricing method, which is also required by GATT rules. This could be accomplished by using the pricing rules set out under section 482 of the Internal Revenue Code or by using one of the two administrative pricing rules set forth in the legislation.

The current DISC provisions would be repealed (except for the use of an Interest Charge DISC by small business, see discussion on page 4), and the accumulated tax-deferred income of a DISC would be deemed previously taxed income and therefore exempt from taxation. Two exceptions from the FSC rules are provided for small business.

FOREIGN PRESENCE REQUIREMENTS

Section 924(d) of the legislation refers to the activities relating to the disposition of export property which must take place outside the United States. These activities include: (1) advertising and sales promotion, (2) the processing of customer orders and the arranging for delivery (outside the United States) of the export property, (3) transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer, (4) the determination and transmittal of a final invoice or statement of account and the receipt of payment, and (5) the assumption of credit risk.

While the Chamber has been concerned over the lack of definition of these activities, we understand that the Administration will be releasing a general explanation of S. 1804 which will clarify these rules. We assume this document will serve as a basis for Treasury regulations so that corporations will have the guidance they need in determining how to comply with the FSC rules.

SMALL BUSINESS PROVISIONS

The U.S. Chamber has long advocated simplification of the present DISC provisions in order to allow more small businesses to use them. The Small Business Administration estimates that approximately 20,000-30,000 small manufacturers are capable of exporting but do not because they are unaware of the possibilities exporting can offer them or are reluctant to get involved in what they perceive as a complex and complicated process. We strongly believe that any legislation which Congress enacts to replace the DISC should not be so complicated and costly as to prohibit current small business DISC users and potential small business exporters from using the FSC.

The rules for taxation of the income of a FSC are simpler than the rules under DISC. The elimination of the rule requiring that tax deferred income under the DISC be invested in certain qualified export assets is particularly important for small business because it allows these companies, which have more difficulty in obtaining competitive financing, unrestricted use of the income which is exempt from taxation. Equally important for small business is the elimination of other complicated rules and regulations that, if not met, might cause a small business to unwittingly terminate its DISC status.

Although the taxing rules under the FSC proposal are simpler than under the present DISC rules, the requirement that export sales must be made through a foreign corporation which must perform certain economic activities outside the United States causes additional burdens for small business. S. 1804 contains two exceptions from the general FSC rules for small businesses: (1) the Interest Charge DISC and (2) the Small FSC provisions.

1. Interest Charge DISC

Under this provision, businesses with less than $10 million in qualified export receipts would be permitted to continue to use their DISCs and to pay interest, at the Treasury bill rate, on the taxes which are deferred. We do not perceive this option as relief for small business from the burden of having to perform export sales activities outside the United States because small businesses selecting this alternative would lose a large portion of the benefit which they presently receive under DISC.

Since the only value of a tax deferral is the time value of money, paying an interest charge on that deferral would eliminate its benefit. In this case, the value to small business of this proposal would be the difference between the Treasury bill rate at which they would be paying interest (approximately 8.9 percent on November 16, 1983) and the cost of borrowing money (typically approximately 1.5 points over prime, or 12.5 percent).

This provision will not come close to giving small businesses a benefit equal to what they are receiving under the present DISC rules. Now, a small business is essentially receiving an interest-free loan on 42.5 percent of its taxable DISC income. Under the Interest Charge DISC provision, a small business would be receiving an 8.9 percent loan on 100 percent of its taxable DISC income. Therefore, the only way in which the small business would receive equivalent benefits under these rules is if it can receive an extraordinarily high rate of return on its investment.

This approach will also cause problems for small business because, as deferred income accumulates over the years, larger and larger amounts of interest on these deferred taxes will become due, and at some point these annual interest charges could surpass a small business user's annual DISC income. Additionally, small business would still have to cope with the complications of present DISC provisions which might cause them unwittingly to terminate their DISC status and the requirement that deferred DISC income must be invested in qualified export assets.

2. Small FSC Provisions

Under this provision, businesses with less than $2.5 million in foreign trading gross receipts would be able to utilize the new FSC provisions if they are incorporated outside the United States, maintain an office outside the United States, maintain a set of permanent books of account at that office, and have at least one non-resident of the United States as a member of the board of directors of the FSC. However, the small FSC would not be required to perform economic activities outside the United States. We believe that small businesses would be able to comply with this provision if they can maintain the office outside the United States on a shared basis. However, we believe that by limiting the availability of this provision to businesses with less than $2.5 million in foreign trading gross receipts, the vast number of small businesses presently using DISC will still not be able to use the FSC.

Recent Commerce Department statistics show that manufactured goods which are eligible for DISC benefits currently provide approximately a 7 percent rate of return on sales. If the rate of return on export sales is 7 percent, then a company with $2.5 million in export sales will have a tax exemption of $29,750 (17 percent of $175,000, the profit on $2.5 million in sales) by using the FSC. This exemption could very quickly be eaten away by the cost of performing the foreign economic activities required by this proposal. Therefore, we suggest that the Small FSC option be expanded to allow businesses with up to $10 million in foreign trading gross receipts to be able to use this option for a transitional period of five years during which time the definition of a Small FSC would be phased down to $5 million. At the end of the five year period, only businesses with less than $5 million in foreign trading gross receipts would be able to use this option. This approach would give time to many larger small businesses and medium-sized businesses to develop the capability to comply with the requirements of the FSC, which they would have difficulty in doing immediately because they do not have established overseas operations as larger companies do. (This suggestion can be accomplished by amending section 924(b)(2)(B) as illustrated in the Appendix).

3. Multiple Ownership FSC's

S. 1804 is drafted to permit several companies to jointly own a FSC. We believe this approach may be important for small business, especially to the extent it may be tied into the new rules for export trading companies. Encouraging small businesses to enter the export market is important for the growth of the U.S. economy. This is being done already by the Commerce Department through its promotion of the export trading company concept. If export trading companies could also provide small business the opportunity to use FSC's, they might attract more small businesses to the export market.

INCOME FROM TRADE RECEIVABLES OF RELATED PERSONS

Many domestic and multinational corporations factor accounts receivable as a means of obtaining financing for continuing operations. Generally, this is done by selling the receivables, at their fair market value, to a purchaser. Often times the purchaser may be a related corporation which has more cash than the party selling the receivables. The purchaser will attempt to collect on the receivables and will have income on the excess collected over the purchase price of the receivables and costs incurred in collecting on the receivables. Multinational corporations may pursue this course of action (known as factoring of receivables) to make use of excess capital of a foreign subsidiary for financing the operations of the U.S. company.

Section 2(c) of S. 1804 would treat the income earned by a foreign subsidiary which purchases receivables of a related company as Subpart F income. This means that the U.S. parent company would be taxed currently on its income even if it is not distributed to the parent. This provision carries an effective date of August 4, 1983, the date on which the bill was introduced.

We believe that the factoring of receivables supplies an important source of financing for businesses and that its tax treatment should not be changed. Where factoring is used to obtain financing for a U.S. parent from a foreign subsidiary, which is the situation addressed by section 2(c), that capital may be used for further exporting. We, therefore, believe it is totally inappropriate to include a provision which restricts a source of capital for export financing in a bill which is designed to aid exporters. Furthermore, the inclusion of this provision in S. 1804 is contrary to the Administration's stated intent in proposing DISC-alternative legislation, which was to change the format to comply with GATT and to avoid any new tax increases. If Congress or the Treasury Department believes that abuses exist in this area, those abuses should be addressed in separate legislation.

Additionally, we consider it to be bad tax policy to enact tax provisions retroactively. Such action by Congress is extremely unfair to the vast majority of taxpayers who become aware of proposed changes in the law only after enactment. It also makes it impossible for businesses to plan transactions in advance.

NON-EXEMPT FOREIGN TRADE INCOME

Section 921(d) of the legislation provides that non-exempt foreign trade income of an FSC will be considered U.S. source income and, therefore, restricts the availability of the foreign tax credit. We believe that this provision is inappropriate. The source of this income should be determined under the principles contained in sections 861-864 of the Internal Revenue

Code. To the extent such income is considered to be from foreign sources under these rules and is appropriately taxable by a foreign jurisdiction, a foreign tax credit should be allowed. Section 921(a) would prohibit companies from using existing foreign subsidiaries as FSC's because to the extent that these subsidiaries generate taxable income from other activities, they would be denied a foreign tax credit.

TRANSITION RULES

Greater flexibility in the transition rules may be needed to ease the shift from DISC to FSC. For example, a transition rule is needed to deal with a sale which has taken place under DISC for which income will not be recognized until some time after the FSC rules are enacted, as would be the case with a taxpayer using a long-term contract method of accounting. We would appreciate the opportunity to work with the Committee staff on any other transition problems which may arise.

CONCLUSION

The Chamber of Commerce of the United States supports the efforts of the Office of the United States Trade Representative and the Treasury Department in designing a DISC-substitute which addresses the concerns of signatories to the GATT without harming businesses which presently use DISC. We commend the Chairman for introducing legislation and promptly holding hearings on this subject which is of such immediate concern in our foreign trade policy negotiations. However, it is essential that certain modifications be made in this legislation so that it does not harm businesses who are presently using DISC. We would be pleased to work with the Committee in making those needed modifications.

Appendix

Amendment to Small FSC Provision of S. 1804

Amend Section 924(b)(2)(B) to read:

(i) In general -- any foreign trading gross receipts of a small FSC for the taxable year which exceed $5,000,000 shall not be taken into account in determining the exempt foreign trade income of such corporation and shall not be taken into account under any other provisions of this subpart.

Add new section 924(b)(2)(B)(v):

(v) Phase-in of limitation --

If the taxable year begins in calendar year	Subsection (i) shall be applied by substituting for "$2,500,000" the following amount:
1984	$10,000,000
1985	9,000,000
1986	8,000,000
1987	7,000,000
1988	6,000,000

STATEMENT OF GLENN W. WHITE, DIRECTOR OF TAXES, DOW CHEMICAL CO., ON BEHALF OF CHEMICAL MANUFACTURERS ASSOCIATION, WASHINGTON, D.C.

Mr. **White**. Thank you, Senator.

I am Glenn White, chairman of the Tax Policy Committee of the Chemical Manufacturers Association. We have submitted a full statement for the record; however, several points need to be established concerning the proposed legislation.

The United States has agreed with GATT to change the DISC. S. 1804 would establish a substitute for the DISC which parallels the system GATT has declared to be legal.

The United States needs exports. Our growing trade deficit is a severe problem. The chemical industry accounts for about 10 percent of total U.S. exports, and is a major DISC user.

World chemical markets are becoming more intensely competitive and more difficult to penetrate. More than 10 percent of U.S. industrial employment is export dependent. If nothing is done to meet our commitment to GATT we will probably be subject to trade retaliation. We will lose export sales if we do not act to change the DISC.

There are minor problems in the legislation that need your attention, which we have detailed in our statement.

The legislation is revenue-neutral. CMA urges you to act swiftly to adopt this bill.

Senator **Danforth**. Thank you, sir.

Mr. Fayhee.

[Mr. White's prepared statement follows:]

STATEMENT OF
GLENN W. WHITE
THE DOW CHEMICAL COMPANY
on behalf of
CHEMICAL MANUFACTURERS ASSOCIATION
before the
SENATE COMMITTEE ON FINANCE

My name is Glenn White. I am the Chairman of the Tax Policy Committee of the Chemical Manufacturers Association.

I am appearing before you today to testify in support of S. 1804, which would provide for the creation of a "Foreign Sales Corporation" to replace the current Domestic International Sales Corporation. The Chemical Manufacturers Association ("CMA") strongly supports S. 1804, although we have reservations about certain provisions of the bill.

CMA is a non-profit trade association which represents more than 90 percent of the productive capacity of basic industrial chemicals in the United States. The United States chemical industry is a very significant source of exports. In a time when there is a substantial deficit in the United States balance of trade, this country exports more than twice as many chemicals and related products as it imports. In 1982, the United States imported $243,952 million worth of merchandise, while it exported only $212,275 million of both domestic and foreign merchandise. Of these amounts, 9.6 percent of all United States merchandise exports originated in the chemical and related industries. In contrast, only 3.9 percent of all imports into the United States were of chemical products. From January through June of 1983, the chemical industry was the source of 9.9 percent of all United States merchandise exports. However, imports of chemical products totaled only 4.4 percent of all United States merchandise imports. (United States Bureau of the Census, Highlights of United States Export and Import Trade, Report FT990 (December 1982); United States Bureau of the Census, Highlights of United States Export and Import Trade, Report FT990 (June 1983).) These figures demonstrate that the United States chemical industry is a very important contributor to the United States export economy.

Strong United States exports are vital to this nation's economy. Export production accounts for a substantial percentage of employment in United States factories. In 1980, exports accounted for over 12 percent of all employment in United States factories. (Report of the President on Export Promotion Functions and Potential Export Disincentives, September 1980). Many economists indicate that approximately 40,000 jobs would be affected by a $1 billion change in the value of net exports from the United States.

Although exports are crucial to our economy, in recent years, there has been a sharp downward trend in the export of United States-manufactured products. In particular, the share of the United States in the world chemical trade has decreased substantially. One report noted a drop from 22 percent in 1962 to 10 percent in 1979. (Chemical and Engineering News). Recent years have shown even stronger competition in the chemical field in foreign markets.

In order for United States firms to compete effectively in foreign markets, some governmental support is required. Incentives for investment in export-related assets, as opposed to assets to be used in purely domestic industry, are essential to aid the United States in obtaining satisfactory export levels. The Domestic International Sales Corporation ("DISC") tax provisions have been an important incentive. Studies in 1980 showed that United States exports, as a percentage of Gross National Product, grew ten times faster after the enactment of DISC than in the preceding decade. This increase in exports in the 1970's accounted for an additional eight percent of employment in United States factories over the pre-DISC export employment figure of four percent.

Unfortunately, our GATT trading partners contend that our DISC rules result in an illegal subsidy under GATT. In order to maintain healthy international trading relations, the United States is undertaking to find an alternative to DISC that conforms to GATT. Any alternative, however, must be at least as supportive of United States exports as DISC has been if we are to maintain our present level of exports and the United States jobs that those exports represent.

CMA supports S. 1804 as a viable and acceptable alternative to DISC. S. 1804 will serve to keep many jobs and activities related to United States exports within the United States. The bill will continue the government's crucial commitment to provide incentives to investment in export-related assets. The bill will disrupt as little as possible the structure and operation of the export trade developed under the DISC provisions. Furthermore, the Foreign Sales Corporation, because of its substantial foreign activity requirements, should successfully satisfy the demands of our GATT trading partners.

CMA has reservations about some of the proposed provisions. In particular, CMA is concerned that the foreign presence requirements are unnecessarily strict and will force the transfer overseas of too many United States-based jobs and activities. In addition, CMA is concerned that some small businesses will be disadvantaged by the foreign presence requirements. These reservations are set forth in more detail in the attached memorandum. Furthermore, we believe that the so called "factoring" provision in section 2(c) of the bill has implications that go far beyond DISC or Foreign Sales Corporations and should not be addressed in this legislation.

Despite the fact that CMA has reservations about certain individual provisions in the proposal, CMA is strongly in support of the bill as a whole. It is critical that the uncertainty surrounding the tax treatment of exports, which has been created by the GATT controversy, be resolved. The Foreign Sales Corporation is a reasonable and workable replacement for DISC and will serve to allow responsible tax planning by the export sector.

Therefore, the Chemical Manufacturers Association urges that you support the enactment of S. 1804.

Chemical Manufacturers Association
Technical Comments on S. 1804

1. Section 921(c). -- This provision of the Bill denies the investment tax credit and certain other credits to an FSC. The investment tax credit should not be denied with respect to nonexempt foreign trade income. Depreciation is allowed with respect to nonexempt foreign trade income, and the investment tax credit and other credits should be allowed on the same basis.
2. Section 921(d). -- There is no reason that nonexempt foreign trade income of an FSC should be sourced as domestic source income under section 921(d), thus severely restricting any foreign tax credit. Further, where the FSC is not engaged in trade or business in the U.S., directly or through an agent, the nonexempt portion of its foreign trade income should not be taxed to the FSC.
3. Section 922(a)(1)(D)(ii). -- Permanent books of account should be defined not to require a comprehensive ledger or journal system. Rather, summary balance sheets or operating statements should be adequate.
4. Section 923(a)(1). -- It should be made clear that it is possible to choose among the two administrative pricing rules as well as the 482 pricing mechanism on a sale-by-sale (or group of sales-by-group of sales) basis. In other words,

foreign trade income of an FSC is made up of various items of income computed under the best pricing method in the case of each item (or group of items), similar to DISC.

5. Section 924. -- Confirmation is required that sales for resale in the export market will qualify for FSC benefits under provisions similar to those contained in the DISC regulations.
6. Section 924(b)(2). -- A substantial increase over the present $2,500,000 amount allowable as foreign trading gross receipts of a small FSC is desirable. Further, taxable income, rather than gross receipts, would be a more appropriate measurement for small FSC's.
7. Section 924(c)(2). -- This provision requires, among other things, that the principal bank account of an FSC be maintained outside the United States. The Bill should be clarified to state that the principal bank account is that which is designated the principal bank account by the FSC.
8. Section 924(d)(1)(A). -- This subsection requires that the FSC or any person acting under a contract therewith participate outside the U.S. in the solicitation, negotiation, or the making of the contract relating to the export transaction. Many taxpayers will contract with related incorporated sales subsidiaries to perform solicitation, negotiation, or the making of the contract for the FSC. If such foreign sales subsidiary (the contractee) is required to perform these functions as an agent of the FSC, the FSC would

probably be subject to tax in the foreign country since the existence of a dependent agent would almost certainly be considered a "permanent establishment" in that country. This problem can be eliminated by defining "participate" in such a way that the contractee need not be an agent of the FSC.

9. Section 924(d)(2). -- With respect to the alternative 85% test, the Bill provides that "a corporation shall be treated as satisfying the requirements of paragraph (1)(b) with respect to any transaction if, with respect to each of at least two paragraphs of subsection (e), the foreign direct costs incurred by such corporation attributable to activities described in such paragraph equal or exceed 85% of the total direct costs attributable to activities described in such paragraph." Either the phrase "incurred by such corporation" should be deleted from this paragraph, or that same phrase should be inserted after the words "total direct costs" in this paragraph.

10. Section 924(d)(3)(A)&(B). -- These sections define total direct costs and foreign direct costs. The definition in Subsection (A) includes activities performed at any location by the FSC or any person acting under a contract with such FSC. The definition in Subsection (B) of foreign direct costs makes no reference to persons acting under a contract with such FSC. To clarify this, the "person acting under a

contract with such FSC" language should be repeated in Subsection (B) or the definition in Subsection (B) should read "total direct costs as defined in Subsection (A)."

11. Section 924(e)(1). -- Category (1) relating to advertising should clearly reflect that general advertising within the U.S. is not included in this category.

12. Section 924(e)(3). -- This provision refers to the cost of transportation from the time of acquisition by the FSC to the delivery to the customer. Cost compilation might be affected by the terms of sale. Under CIF terms (Cost, Insurance, and Freight), the shipping charges are separately identified on the invoice and/or related documents. In this instance, it might be argued that the seller is arranging for insurance coverage and freight as agent of the purchaser since the cost of these items are passed through without markup. In contrast, under FOB terms (Free on Board), the freight charges do not appear as separate items on the invoice, and clearly such costs are borne by the seller on its own behalf. The inclusion or noninclusion of freight in the direct costs test should not be dependent upon the formal terms of sale, since the two terms effect the same economic result. The actual freight paid by the FSC should be included irrespective of the terms of sale (CIF or FOB).

13. Section 924(e)(4). -- With respect to the requirement of "determination and transmittal of final invoice of statement of account and the receipt of payment" under section 924(e)(4), the word "determination" is confusing and should be changed to "calculation".

14. Section 924(e)(5). -- It should be made clear what costs are involved in the "assumption of credit risk." Are the costs of credit insurance and investigations included?

15. Section 925(b). -- This provision provides rules for commissions, rentals, and marginal costing. Although the same language is used as appears in the DISC legislation under §994(b), language should be included to the effect that the rules for commissions, rentals, and marginal costing should be the same as contained in §994 and the Treasury Regulations issued thereunder as of the date of enactment of the FSC legislation.

16. Section 927(d)(1)(B). -- This section defines carrying charges, which are taxed under §921 of the FSC legislation as effectively connected income, as including any amount in excess of the price for an immediate cash sale. It is unreasonable to subject to taxation unstated interest on any terms other than a cash sale when export transactions commonly have terms of from 60 to 180 days. The §482 standard of 180 days for trade receivables should be applied in this instance so that no interest income is attributed to receivables up to 180 days.

17. Section 927(d)(2)(B). -- This section permits grouping of transactions, to the extent provided in regulations, for all purposes under FSC based on product lines or recognized industry or trade usage. The phrase "to the extent provided in regulations" should be stricken. The ability to group should not be contingent on the issuance of regulations, which may take several years, but the Treasury should be permitted to issue regulations implementing grouping, just as Treasury is permitted to issue regulations describing or implementing any other section of the Code. The basic permission to group based on product lines or recognized industry or trade usage should not be discretionary with Treasury.

18. Section 927(e)(1). -- This section relates to source rules for related persons and would appear to require parallel calculations under the DISC pricing rules. Such parallel calculations are burdensome and should not be required. The meaning of this section should in any event be clarified.

19. Section 4 of the Bill. -- Greater flexibility in transitional rules is required to ease the change from DISC to FSC. Since the proposed bill ends the tax year of existing DISC's on 12/31/83, it appears that existing DISC's will be required to satisfy the assets tests of §992(a)(1)(B) as of 12/31/83. This can be burdensome where the DISC is on a fiscal year basis and is not used to qualifying on 12/31/83, and also because it is uncertain when the law will be

enacted. Since the asset qualification tests are in effect being abandoned anyway by adoption of the FSC legislation, a provision should be included expressly eliminating the asset qualification test for DISC's on 12/31/83 if the shareholder uses an FSC thereafter.

20. Section 4(b)(4) of the Bill. -- Relief from section 367 and other Code provisions is necessary in the case of those companies wishing to transfer assets or businesses presently in other subsidiaries to the FSC in order to conform to the foreign presence requirements.

21. In the General and Technical Explanation which preceded the Bill, the accumulated income of an Export Trade Corporation was to be treated as "previously taxed." This provision should be retained in the Bill.

STATEMENT OF ALFRED DeGREGORY, VICE PRESIDENT, FINANCE, CALIFORNIA ALMOND GROWERS EXCHANGE, SACRAMENTO, CALIF., ON BEHALF OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, D.C.

Mr. **DeGregory**. Thank you.

Mr. Chairman, my name is Alfred DeGregory. I am here with Mike Fayhee. Together we represent the National Council of Farmer Cooperatives. The national council represents more than 90 percent of all the farm cooperatives in the country. Approximately two-thirds of all farmers belong to one or more cooperatives.

We have asked to testify because of our concern about S. 1804, the Foreign Sales Corporation Act of 1983. I will confine my comments to three major points.

First, I would like to stress that we strongly support the idea of providing tax incentives to all U.S. exporters as a means to increase the export of American goods and products.

Second, farmers and their cooperatives have been effectively precluded from taking advantage of the tax deferral benefits provided by domestic international sales corporations, as they are commonly known.

Third, the Foreign Sales Corporation Act of 1983 must provide the ability for farmers through their cooperatives to take advantage of its tax incentives.

Our company recognized the disability of farmer cooperatives to use DISC and has spent a good deal of time trying to make it work—the DISC legislation. It ultimately did not work.

This has created an inequity to farm cooperatives that we think must be addressed in this legislation.

Thank you.

Senator **Danforth**. And finally, Mr. Joranko.

[Mr. DeGregory's prepared statement follows:]

Statement of

Alfred D. DeGregory
Vice President-Finance
California Almond Growers Exchange

and

Michael R. Fayhee
Partner
McDermott, Will & Emery

On Behalf Of The
National Council of Farmer Cooperatives

November 18, 1983

Introduction

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes 109 regional marketing and farm supply cooperatives, the 37 banks of the cooperative Farm Credit System, and 31 state councils of farmer cooperatives. The National Council members handle practically every type of agricultural commodity produced in the United States, market these commodities domestically and around the world, and furnish production supplies and credit to their farmer-members and patrons. Two-thirds of United States farmers are affiliated with one or more cooperatives. The National Council represents about 90% of the more than 6,200 farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

On behalf of its member agricultural cooperatives and their farmer-members, the National Council is presenting testimony concerning the Foreign Sales Corporation Act of 1983 (S.1804). This Act would provide certain tax incentives to U.S. exporters utilizing a Foreign Sales Corporation (FSC). S.1804 would replace the present provisions in the Internal Revenue Code which provide tax incentives to U.S. resident shareholders of a Domestic International Sales Corporation (DISC).

The National Council and its members are in complete agreement with the basic tax policy embodied in S.1804, i.e., that there should be tax incentives offered to U.S. persons who engage in the export of U.S. goods and services. Given the increased risk and expense involved in export activities, and the benefits to be derived by the entire nation from successful export endeavors, this policy deserves the active support of the Congress and the Administration. However, as now drafted, S.1804 would deprive cooperatives and their members of any meaningful participation in the proposed tax incentives. Set forth below is a summary of the basic Federal tax provisions affecting cooperatives and their members, the reasons cooperatives will not be able to benefit from S.1804, and suggested amendments to S.1804.

Taxation of Agricultural Cooperatives and Their Members

Farmer marketing cooperatives are organizations engaged in marketing the products of their members. A fundamental principle of cooperatives is that they are owned and controlled by their members. An equally important principle is that a farmer cooperative operates at cost and returns all sales proceeds from the marketing of farm products in excess of the marketing expenses to the farmer-members on a patronage basis. Because of these characteristics, farmer cooperatives have been said to be unique in the sense that they are, in reality, simply an extension of their farmer-members.

A number of areas of Federal law have recognized the special nature of agricultural cooperatives. For example, special provisions exist in the anti-trust, securities and transportation laws. In the tax law, farmer cooperatives and their members together are subject to U.S. income tax on the basis of the single tax principle embodied in Subchapter T of the Internal Revenue Code (Sections 1381-1338). Under this principle, the earnings of a cooperative will be taxed to the cooperative's members and not the cooperative if the earnings are distributed to the members on a patronage basis. This is often referred to as the single tax concept.

Because of the special tax provisions contained in Subchapter T, agricultural cooperatives have been unable to effectively utilize the tax incentives provided in the existing DISC provisions. The DISC legislation permits an exporter to defer tax on a portion of the income derived from export of U.S. goods and services. Because a cooperative must forfeit the single tax concept of Subchapter T in order to have taxable income to allocate to the DISC, these provisions do not offer an export incentive to cooperatives. Stated differently, to use the DISC provisions, a cooperative must be prepared to subject a farmer's earnings to double tax. As a consequence, cooperatives have operated at a competitive disadvantage in the export arena as compared to proprietary concerns which have the ability to defer taxes on a portion of export profits virtually permanently.

The DISC provisions are also not available to the individual farmer-members of cooperatives. As a practical matter, individual farmers are not sufficiently large to engage in direct exporting. Moreover, the Internal Revenue Service has taken the position in Rev. Rul. 77-484 that products marketed by a farmer's cooperative will not qualify as "export property" with respect to the farmer unless the product is physically segregated by the cooperative for an export sale. Since this is not practical, given the fungible nature of agricultural products, a farmer is precluded from directly utilizing the benefits of the DISC legislation. Thus, a large group of American businessmen whose product is exported are now denied the special tax incentives offered to other exporters.

Impact of S. 1804 on Agricultural Cooperatives and Their Members

Under S.1804, a U.S. exporter will be permitted to establish an FSC in a foreign jurisdiction through which it may conduct its export sales. Profits from export sales transactions will be allocated between the U.S. exporter and the FSC in accordance with certain transfer pricing rules. For example, under one of the administrative pricing rules the FSC will be allocated 23% of the total profits from the export transactions, of which 17% will be exempt from U.S. income tax and 6% will be subject to U.S. income tax. All resulting after-tax profits of the FSC (i.e. both the tax-exempt amounts and the after-tax amounts on the taxable portion) can be repatriated in the form of dividends to the U.S. parent exporter. The U.S. parent exporter will have no further U.S. tax liability with respect to these amounts as a result of a 100% dividend received deduction.

The legislation would permit a farmer to establish an FSC even though the farmer marketed his farm products through an agricultural cooperative. This provision was designed to correct the deficiency described above in the DISC provisions. However, FSCs, unlike DISCs, will require considerable expense and administration. As a consequence, this provision will be of little or no practical significance to farmers of this country.

S.1804 would not prevent a cooperative from forming and operating an FSC. However, as is the case with the DISC legislation, these proposals are in conflict with the single tax principle governing the taxation of cooperatives.

First, a cooperative would have to forego the operation of Subchapter T in order to have taxable income to allocate to the FSC. The taxable income not allocated to the FSC would be subject to double tax. We believe that the portion of the cooperative's earnings not allocated to the FSC should be able to be allocated to patrons under Subchapter T.

Second, under the proposals, a U.S. tax will be imposed on a portion of the FSC income. Even though the after-tax portion of this income may be repatriated tax-free to the U.S. parent cooperative by virtue of the 100% dividend received deduction, this income will ultimately be subject to a second U.S. income tax when distributed to the farmer-members of the cooperative. Subjecting this portion of the income to a double tax is contrary to the single tax principle governing the taxation of farmer cooperatives. Although it may be necessary for reasons associated with GATT to provide for tax to be imposed with respect to a portion of the FSC income, we believe it should be possible to simultaneously preserve the principle of a single tax on these earnings.

Finally, in addition to double tax with respect to the non-exempt portion of FSC earnings, there may also be a double tax under the legislation with respect to the exempt portion of FSC earnings. In many cases a farmer will deliver his farm products to a local cooperative which will, in turn, make delivery to a federated cooperative. The federated cooperative may export directly or make delivery to yet another interregional cooperative which will perform the exporting. Although the cooperative which ultimately performs the exporting will be permitted to receive dividends from an FSC tax free, any subsequent distribution of those dividends will generate multiple levels of taxation, thus providing results contrary to the single tax concept. Again, we believe that it would be consistent with the tax principles governing cooperatives to impose a single tax only on these earnings.

In sum, S.1804 will deprive farmers and farmer-owned cooperatives of any meaningful participation in the significant tax benefits being considered to promote export activity and will serve to operate solely for the benefit of proprietary concerns.

Proposed Amendments

In order to provide equitable treatment for agricultural cooperatives and their members, four basic amendments should be made to the proposed legislation.

First, to make the FSC provisions meaningful at the level of the exporting cooperative, combined taxable income under the transfer pricing rules must be calculated prior to any deductions permitted by Section 1382 of the Internal Revenue Code.

Second, the income of the FSC other than exempt foreign trade income should be deemed Subpart F income and taxed to the parent cooperative as patronage sourced income under Subchapter T rather than to the FSC.

Third, Section 245 of the Internal Revenue Code should be further amended to provide for a 100% dividend-received deduction for any corporation receiving a dividend distribution of the tax-exempt portion of FSC income from a cooperative to the extent such distribution is attributable to a dividend received from an FSC. This will permit a pass through of the FSC dividend relating to the tax-exempt portion of FSC income without generating multiple tiers of tax.

Fourth, although tax will be paid by the individual farmer at the time of receipt of distributions attributable to the exempt portion of FSC income, the tax rate should not exceed the rate assessed against long-term capital gains. In proprietary concerns, it can be expected that the dividends received from an FSC will not be distributed to shareholders as dividends but, rather, will increase the value of the shareholders' interest in the proprietary concern. In most instances these shareholders will have the opportunity to realize that value subject to long-term capital gain rates. Farmer-members who are owners of their cooperatives should be entitled to the same benefit.

STATEMENT OF RONALD J. JORANKO, DIRECTOR OF TAXES, TRW INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Joranko**. I am Ronald Joranko, along with Robert Ragland, director of taxation for the National Association of Manufacturers. I am appearing on behalf of the NAM.

We recognize that a substitute for the current DISC provision seems to be inevitable, and therefore strongly support in principle the administration's proposal for a Foreign Sales Corporation, or FSC. We believe that the U.S. Trade Representative and the Treasury Department must continue working together with business groups to modify or further clarify the foreign-presence requirements so that they would be more compatible with the way American exporters operate.

We must be careful to insure that it provides tax benefits comparable to DISC without being overly complex. We support the provision in the legislative proposal that allows the parent company to receive tax-free distribution of DISC-exempt income and all nontaxed DISC income up to the effective date of the tax bill. This in fact is the incentive for exports, and without this provision the NAM could not be supportive of the bill.

At this point I would like to introduce for the record a summary of the NAM's position regarding Senate bill 1804, a comprehensive text addressing the FSC proposal, a study of foreign tax practices affecting exports prepared by Cole & Corette, and the text of a 1979 export study conducted by Price Waterhouse.

Mr. Chairman, this concludes our remarks. I would be pleased to answer any questions you may have.

[Mr. Joranko's prepared statement, the Cole & Corette study, and the Price Waterhouse study follow:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF MANUFACTURERS
ON
THE FOREIGN SALES CORPORATION
BEFORE THE
SENATE FINANCE COMMITTEE

PRESENTED BY
RONALD J. JORANKO
DIRECTOR OF TAXES
TRW INCORPORATED
ACCOMPANIED BY
ROBERT A. RAGLAND
DIRECTOR OF TAXATION
NATIONAL ASSOCIATION OF MANUFACTURERS

NOVEMBER 18, 1983

EXECUTIVE SUMMARY

I am Ronald J. Joranko, Director of Taxes at TRW Inc. I am accompanied today by Robert Ragland, Director of Taxation for the National Association of Manufacturers. I am appearing today on behalf of NAM's more than 13,000 member companies both large and small, and located in every state, representing 80% of domestic manufacturing and a similar percentage of industrial employment.

We appreciate this opportunity to appear on the matter of S.1804, legislation replacing the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code (IRC) with a Foreign Sales Corporation (FSC). While NAM cannot fully endorse S.1804 at this time, we strongly support in principle this attempt by the Administration to enact an export trade incentive program that is consistent with the terms of the General Agreement on Tariffs and Trade (GATT) and other free trade treaties and agreements. Unreserved endorsement of S.1804 must be withheld pending the agreement of NAM member companies that this proposal will promote equity in international markets for American exports versus foreign exports and pending resolution of a number of technical difficulties noted in our prepared statement.

At this point I would like to introduce for the record a study of Foreign Tax Practices Affecting Exports. Compiled by Cole & Corette, this document amply illustrates the need for an American export incentive program to offset the advantages offered to exporters around the world by their governments.

Recognizing the need for a strong and competitive U.S. export market Congress in 1971 authorized the formation of DISCs to stimulate exports and improve the balance of payments. In addition, DISC was enacted to:

- Create more jobs for American workers and stimulate American industry;
- Achieve manufacturing efficiencies through production for world markets;
- Treat taxes of American export income comparably to export income taxes of many foreign countries.

Its benefits have been dramatic. More than 15,000 DISCs have been organized since DISC became law. U.S. exports, which totaled $43 billion in 1971, increased to a record $236 billion in 1981 before dropping back to $211 billion in 1982 during a worldwide recession. At this point I would like to introduce for the record the text of a study of 1979 exports conducted by Price Waterhouse on behalf of the NAM and six other business organizations. In pertinent part it was found that for every $1 in revenue foregone by the Treasury $1.24 was returned. The August, 1983 Treasury Department report to Congress attributed $7 - 11 billion of 1981 exports to DISC. Increased exports have a substantial impact on the U.S. economy. The Commerce Department estimated that each additional billion dollars of exports creates over 25,000 new domestic jobs. These new jobs tend to be created in the most productive industries which accelerates the nation's economic growth. These benefits have accrued at no cost to the American taxpayer.

Foreign governments have objected to DISC. They allege it to be an unfair export trade subsidy provided by the United States in violation of international trade agreements. United States Trade Representative, William Brock, has stated that the U.S. will replace DISC with export incentives similar to those of our trading partners.

Senate Bill 1804 is the Administration's proposal to eliminate DISC and establish a new export incentive through a mechanism known as FSC (Foreign Sales Corporation). Recognizing that a substitute for the current DISC provision seems to be inevitable, we support in principle the Administration's proposal for an FSC mechanism. However, the FSC proposal will need modification or clarification of the foreign presence requirements and other provisions in order to provide tax benefits comparable to DISC without excessive complexity.

Since most U.S. exporters have been employing the commission rather than the resale type of DISC, they will most likely prefer to use the commission FSC as well. In this regard, some of the foreign presence activities specified in the Administration's proposal are not practical. The five activities specified in Sec. 924(e) of the proposal (advertising and sales promotion, order processing and delivery arrangements, transportation, billing and collection, and assumption of credit risk) are particularly burdensome for a commission FSC.

The proposed requirement that solicitation, negotiation, and contracting occur outside of the U.S. also presents problems for most exporters, both large and small. Application of this requirement to all export transactions may require the FSC to employ or retain marketing personnel outside the U.S. Under DISC, the export company's U.S. based employees can perform these functions. As a result, the FSC proposal may require American exporters to face the unpleasant dilema of either retaining two sets of marketing personnel or transferring the export-related functions outside of the U.S.

The United States Trade Representative and the Treasury Department are working together with business groups to modify or further clarify the foreign presence requirements so that they would be more compatible with the way American exporters operate. We understand that significant progress has been made and we encourage these efforts.

The FSC proposal provides that exempt FSC income may be repatriated tax free to the parent company. Under DISC, most companies keep exempt income non-taxable by having the DISC invest the income in qualified export assets. Since the bill simplifies the tax incentive for exporters we support the bill's provisions that allow the parent company to receive tax free dividends of both FSC exempt income and all non-taxed DISC income as of the effective date of the legislation.

Other concerns, detailed in our prepared statement text, relate to transition rules, definitional matters and other items that are the subject of an ongoing dialogue between the business community, the office of the U.S. Trade Representative, and the Department of Treasury.

In summary, we support in principle the new export incentive known as FSC. However, the current FSC proposal will need modification or clarification of the foreign presence requirements and other provisions in order to provide tax benefits comparable to DISC without excessive complexity.

Mr. Chairman, this concludes our summary remarks, and I offer the balance of our prepared statement for inclusion in the hearing record. I would be pleased to answer any questions you may have.

Thank you.

CURRENT LAW

Enacted in 1971, the Domestic International Sales Corporation ("DISC") provisions of the Internal Revenue Code ("IRC") were designed in part to equalize the cost of American produced goods in international markets vis-a-vis the export trade incentives provided by other major industrialized nations to their multinational firms.

Unlike the territorial based taxing systems used by a number of foreign countries, the United States taxes the worldwide income of its corporations. Given that our system of taxation results in increased costs for American produced goods and services, it was decided to defer taxes on a portion of certain export activity. Federal income tax is deferred on that portion of profits earned abroad by a DISC that are neither distributed nor deemed distributed. (Actual and deemed distributions are taxed to DISC shareholders.) Under the original legislation, 50 percent of the DISC income was taxable as a deemed distribution to its shareholders, whether distributed or not, and tax was deferred on the remaining 50 percent until the income was actually distributed, or some other taxable event occured.

To qualify for this method of taxing export income, a DISC must be incorporated domestically, have only one class of stock, outstanding capital with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the gross receipts and gross assets tests.

The gross receipts test requires that at least 95 percent of the corporation's gross receipts consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside of the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. Dividends on stock of a related foreign export corporation and interest on any obligation which is a qualified export asset are also considered qualified export receipts. Export property must be manufactured, produced, grown, or extracted in the United States. Exports subsidized by the U.S. government or exports intended for ultimate use in the United States do not qualify as export property. A DISC may not engage in manufacturing, producing, growing, or extracting export property.

The gross assets test requires that at least 95 percent of the corporation's assets be qualified export assets. Qualified export assets include inventories of export property, necessary operational equipment and supplies, trade receivables from export sales (including commissions receivable), producer's loans, working capital, investments in related foreign export corporations, obligations of domestic corporations organized solely to finance export sales under quaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association.

When an otherwise qualified DISC fails to meet either the gross receipts or gross assets test, it may continue to qualify as a DISC by making a pro-rata distribution to its shareholders equal to the portion of the income attributable to the ineligible receipts or equal to the fair market value of the unqualified assets, depending on which test is failed, or if both tests are not satisfied, the sum of these amounts. If a DISC is disqualified, or terminates its status as a DISC, the accumulated DISC earnings become subject to taxation over a period of time.

A DISC may act as a principal or as an agent with respect to export property. Its activities can be performed for or on behalf of related or unrelated parties. There is no requirement for a DISC to have employees or real operations. Because of the opportunity for tax deferral, the methods for allocating income between a DISC and its related suppliers are an important part of the DISC legislation. The allocation is determined either on an "arm's-length" basis or under one of two special pricing rules. An allocation can be made allowing the DISC to earn taxable income not exceeding the greater of:

a. taxable income based upon the price actually charged the DISC by its supplier, if that price is justifiable under the section 482 transfer pricing regulations (referred to as the section 482 or arm's-length method);

b. four percent of the qualified export receipts attributable to the sale of export property plus 10 percent of the related export promotion expenses, which are the ordinary and necessary expenses incurred to obtain qualified export receipts (referred to as the 4 percent method); or

c. fifty percent of the combined taxable income of the DISC and its related supplier attributable to qualified export receipts plus 10 percent of the related export promotion expenses (referred to as the 50-50 method).

Neither the 4 percent method nor the 50-50 method can be applied to create a loss for the related supplier while the DISC is earning a profit.

Statutory Amendments. The Tax Reduction Act of 1975 denied DISC benefits to profits arising from exports of products in short domestic supply, as determined by the Commerce Department under the Export Administration Act or by Executive Order of the President. The 1975 Act also removed DISC benefits from exports of natural resource products, such as oil, gas, and minerals, subject to a percentage depletion allowance. The Tax Reform Act of 1976 excluded renewable resources, such as timber, from the natural resource products ineligible for DISC benefits.

The Tax Reform Act of 1976 also included incremental provisions limiting DISC benefits to increases in exports above a certain base period. DISC benefits are limited to the income attributable to export gross receipts over a four-year moving base period. DISCs with adjusted taxable income of $100,000 or less are exempt from the incremental rule; the exemption is phased out as adjusted taxable income increases from $100,000 to $150,000.

In applying the incremental provisions, a DISC's export gross receipts are treated as equal to zero for those base period years in which the DISC did not exist. To prevent a controlling shareholder from gaining an advantage by shifting exports between multiple DISCs, the sales of all DISCs identifiable as part of a controlled group are combined in calculating base period exports.

The 1976 Act also reduced the DISC deferral on sales of military goods to one-half of the amount otherwise allowed. In addition, the Act also lengthened the period for recapture of the deferred tax in the event of disqualification or termination of DISC status to twice the number of years of the DISC's existence, up to a maxiumum period of 10 years.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) increased the deemed distribution rate from a DISC to a corporate shareholder from 50 percent to 57.5 percent of taxable income. This provision, which reduces DISC benefits for such shareholders by 15 percent, applies for tax years of DISCs beginning after 1982.

REASONS FOR CHANGE

For several years, the DISC has been the subject of a dispute between the United States and other signatories to the General Agreement on Tariffs and Trade (GATT), who contend that DISC amounts to an illegal export subsidy which violates the GATT. In 1976, a GATT panel determined that the DISC, as well as certain export tax practices of Belgium, France, and the Netherlands, had some characteristics of an illegal export subsidy. While the United States has not conceded that DISC violates the GATT, the United States agreed to the adoption of the GATT Panel Reports on the DISC and the related tax practices of Belgium, France, and the Netherlands in December 1981. The adoption of all four Panel Reports, however, was subject to an important Understanding.

The Understanding is a formal agreement stating that GATT signatories are not required to tax export income attributable to economic processes located outside their territorial limits. Furthermore, the Understanding states that arm's-length pricing principles should be observed in transactions between exporting enterprises and foreign buyers under common control. Finally, the Understanding states that the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign source income.

A debate in the GATT Council, the ruling body of the GATT, ensued in early 1982 on the interpretation of the Understanding as it applied to the DISC. This debate occupied much of the GATT Council's time during the first half of 1982, delaying progress on other issues of critical interest to the United States.

The European Community (EC) argued that the DISC was an illegal export subsidy because it allowed indefinite deferral of direct taxes on income from exports earned in the United States. The United States defended the DISC on the grounds that its effect on trade as an incentive for exports approximated the effect of the territorial system of taxation used by our European trading partners and found to be consistent with the GATT in the December 1981 Understanding. The majority of the GATT Council members, however, were persuaded by the arguments against the DISC and urged the United States to bring the DISC clearly into conformity with the GATT. The EC went one step further in requesting authorization from the GATT Council to take retaliatory action against the United States. Specifically, the EC wanted to increase trade restrictions on $2.3 billion in U.S. exports to the EC. Other countries also expressed an interest in receiving compensation for the DISC.

To remove the DISC as a contentious issue and to avoid further disputes over retaliation, the United States made a commitment to the GATT Council on October 1, 1982 to propose legislation that would address the concerns of other GATT members. In March 1983, the Administration approved the general outlines of a proposal to replace the DISC with a simpler, GATT-legal, territorial-type system of taxation for U.S. exports. Since under GATT rules, a country need not tax income from economic processes occurring outside its territory, the Administration proposal provides that certain income from economic activities occurring outside the United States is exempt from U.S. tax. The activities related to that income will be undertaken by a foreign sales corporation located outside the U.S. customs territory. A foreign tax credit will not be available with respect to such income. International double taxation is avoided by use of the exemption method. The proposal, according to the Administration, is designed to conform with the letter and spirit of the GATT, while providing benefits to exporters comparable to those of DISC at approximately the same revenue cost to the U.S. Treasury.

PROPOSAL

Summary Explanation. The proposal replaces the DISC with a foreign sales corporation (FSC) through which export sales may be made. It is effective for taxable years of an FSC beginning on or after January 1, 1984. In the typical case, a U.S. parent will form an FSC for the purpose of making its export sales. Provided it satisfies certain requirements, a portion of an FSC's income will be exempt from U.S. tax at both the corporate and domestic corporate shareholder levels. By requiring certain sales activities to be performed outside the United States, the proposal comports with the provision in the GATT Understanding requiring tax exempt income to be from economic processes located outside the United States. These activities must be performed outside the U.S. customs territory either directly by the FSC, or for it on a contract basis.

To comply with the Understanding, the income of the FSC will be determined using arm's-length prices, either actual prices for sales between unrelated, independent parties, or, for sales between related parties, by using the pricing procedures prescribed under section 482 of the Code. Alternatively, one of two allocation rules, designed for administrative convenience to approximate arm's-length pricing, may be used.

The current DISC provision will be repealed. The accumulated tax-deferred income of a DISC will be deemed previously taxed income and therefore exempt from taxation. Because certain small exporters may find it difficult to comply with the foreign presence requirements, the proposal provides two options available only to small businesses.

Qualification as an FSC. A qualifying FSC must have its shares (except for directors' qualifying shares) held by no more than 25 persons. In addition, the FSC must satisfy each of the following four requirements:

(1) maintain an office outside the U.S. territory;
(2) maintain a summary of its permanent books of account at its foreign office, although for purposes of U.S. tax administration and enforcement, complete books and records must be available in the United States;
(3) have at least one director who is resident outside the United States; and
(4) hold a distribution license or sales agency agreement with respect to products purchased from or sold on behalf of a related supplier.

The FSC must be incorporated outside the United States, although it may be incorporated in Guam, the Virgin Islands, the Commonwealth of the Northern Marianas, or American Samoa.

Foreign Trading Income. An FSC that satisfies the requirements of this proposal will be exempt from U.S. tax on a portion of the income from its export sales. Foreign Trading Income (FTI) will be defined as income (including both profits and commissions) derived in connection with foreign trading gross receipts. Foreign trading gross receipts are gross receipts from:

(a) the sale, exchange, or other disposition of export property;
(b) the lease or rental of export property that is used by the leasee outside the United States;
(c) the performance of services that are related and subsidiary to the sale, exchange, lease, rental, or other disposition of export property by the FSC;
(d) the performance of engineering or architectural services for construction projects located outside the United States; and
(e) the performance of managerial services in furtherance of the production of foreign export trading gross receipts.

"Export property" generally means property manufactured, produced, grown, or extracted in the United States for direct use, consumption, or disposition outside the United States. Exports of products with respect to which a deduction for depletion is allowable, other than oil and gas and primary products from oil and gas, will be considered "export property" and thus eligible for FSC benefits.

Foreign trading gross receipts does not include any interest, dividends, income from intangibles, or other type of investment income.

Income Allocation Rules. To conform to the December 1982 GATT Understanding, arm's-length pricing principles will govern the transfer of export property from the U.S. supplier to its related FSC. Hence, the allocation of income between the FSC and its suppliers will be based on arm's-length standards. Taxpayers may allocate income to the FSC based on prices (i) charged between unrelated parties not under common control, or (ii) determined under any of the pricing methods described in the section 482 regulations. Alternatively, as a matter of administrative convenience, the taxpayer may use one of the following two administrative pricing rules for allocating income to the FSC:

(a) 23 percent of the combined taxable income (CTI) earned by FSC and its related supplier or
(b) 1.83 percent of the FSC's foreign trading gross sales, but not more than 46 percent of the CTI.

To be eligible to use either of the administrative pricing rules, the FSC must perform the following activities related to its sales or must have such activities performed for it on a contract basis:

(1) solicit orders from, negotiate contracts with, and accept orders of customers;
(2) process customer orders and arrange for delivery;
(3) arrange and pay for domestic and foreign transportation;
(4) bill customers and receive payments;

(5) pay for advertising and sales promotion activities; and
(6) assume credit risks on sales.

The FSC must be responsible for these activities to meet the requirement in the GATT Understanding that arm's-length pricing principles be observed in transactions between related parties. By carrying out these activities, or arranging to have them performed on the FSC's behalf, the income allocation to the FSC, under either administrative allocation rule, approximates the income allocation under the arm's-length transaction method. Activities (1) through (6) above can be performed by the FSC or for it on a contract basis in any geographic location including the United States.

Tax Exempt FTI. A portion of the FSC's FTI will not be subject to U.S. direct taxation and will be eligible for distribution to U.S. corporate shareholders on a tax exempt basis. This exempt portion of FTI arises from economic activity actually conducted outside the U.S. customs territory. This foreign activity provision is necessary to meet the GATT requirement that the tax exemption be related to economic processes outside the territorial limits of the exporting country.

If an FSC purchases export property from an independent party, or if export property is transferred to an FSC from a related party on the basis of section 482 transfer pricing rules, 34 percent of the FSC's income will be exempt from U.S. tax, provided it satisfies the foreign economic presence tests described below. The objective of this requirement is to ensure that a sufficient amount of foreign activity is undertaken to relate the tax exemption to offshore activity so as to meet the GATT requirement.

If one of the two administrative pricing rules is used by a taxpayer to allocate income to the FSC, tax exempt income will be determined under corollary administrative allocation rules to equal either 17 percent of CTI, or 1.35 percent of the FSC's gross sales up to a limit of 34 percent of CTI. To comply with GATT, the FSC will be required to satisfy the foreign economic presence requirements explained below.

The tax exempt portion of the FTI will not be subject to U.S. direct taxation at the FSC level nor included in the income of a U.S. shareholder under subpart F. In addition, domestic corporate shareholders will be allowed a 100 percent dividends received deduction with respect to actual dividends from distributed earnings attributable to the tax exempt FTI. The dividends received deduction will be in lieu of a foreign tax credit or deduction for foreign taxes. Double taxation is therefore avoided by use of the exemption instead of the credit method. Other earnings of the FSC will remain taxable to the domestic corporate shareholder on a current basis and will be eligible for a foreign tax credit. A shareholder of an FSC that is not a domestic corporation will not be allowed a dividends received deduction with respect to FSC distributions.

Required Foreign Economic Activities. To qualify for tax exemption and satisfy the GATT requirement pertaining to foreign economic processes, the following activities must be performed outside the United States by the FSC or for it under a contract arrangement outside the United States:

(1) Participate in the solicitation, negotiation, or acceptance of all its sales which give rise to foreign trading gross receipts. Solicitation includes telephone, telegraph, and mail communications to unrelated customers, either actual or potential, but does not include advertising. Negotiation includes any communication relating to the terms of sale. Acceptance means formal legal acceptance of a contract.

(2) Activities accounting for 50 percent of the direct costs associated with all five of the following items, or 85 percent of the direct costs associated with each of two of the items:

(a) processing customer orders and arranging for delivery;
(b) billing customers and receiving payment;
(c) arranging and paying domestic and foreign transportation;
(d) paying advertising and sales promotion expenses; and
(e) assuming credit risk.

In applying the percentage tests, costs incurred by the FSC and its agents with respect to these activities will be counted. Activities related to the requisite percentage of those costs must be performed outside the United States to satisfy the tests.

(3) Activities that account for 85 percent of the direct costs of each of the following items: meetings of the board of directors and shareholders of the FSC; maintenance of the FSC's separate bank account; and disbursement of dividends, legal fees, board of director and officers salaries, and accounting fees of the FSC.

Small Business Exception. In order to provide relief for the small exporters who may find the foreign economic activity requirements onerous, small businesses will be eligible for two alternatives to the FSC rules: the small DISC interest charge exception, and the small FSC foreign presence exception.

A DISC with $10 million or less of qualified export receipts may elect to continue to be treated as a DISC. Deemed distributions with regard to base period exports (the incremental provisions) and of one-half of the DISC's income would be eliminated. Thus, except for export sales of military property, substantially all of the DISC's income will be eligible for tax deferral, but the tax otherwise due on the deferred income will be subject to a deductible arm's-length interest charge based on the Treasury bill rate. If the DISC's qualified export receipts exceed the $10 million threshold, income attributable to the excess receipts will be deemed distributed to the shareholders and fully taxable. The DISC, however, may continue to quality as a DISC. Any excess above the $10 million threshold cannot be channeled through an FSC.

Alternatively, if an FSC has foreign trading gross receipts of $2.5 million or less, the FSC may elect to use the administrative allocation rules without meeting the foreign presence requirements described in categories 1 through 3. If foreign trading gross receipts exceed $2.5 million, the income derived from receipts in excess of the $2.5 million threshold will not qualify as foreign trading gross receipts. Foreign trading gross receipts of FSCs within a controlled group shall be aggregated for purposes of calculating the $2.5 million gross receipts threshold.

DISC: PAYING ITS OWN WAY.

The Domestic International Sales Corporation ("DISC") provision of the Internal Revenue Code was the subject of a comprehensive study by the Price Waterhouse Company in 1982. Commissioned by the NAM and six other major business organizations, that study found in pertinent part that DISC costs were more than offset on a dollar for dollar basis in the form of new Treasury revenues that would not have been realized were it not for increased export trade. In DISC year 1979, DISC stimulated additional exports valued between $1.5 and $7.0 billion. Foregone Treasury revenues of $994 million[1] on these sales generated additional Federal tax revenues - corporate, personal and payroll - of $1.03 billion, that is $1.24 in revenue feedback for every $1.00 in cost or a net increase of 24 cents on every dollar invested. In this case repeal of DISC would not only reduce exports by $5.3 billion, but cost the Treasury $99 million in net tax collections.[2] The current public policy implications of this study are clear: in a rush to satisfy the demands of our foreign trading partners we should be more measured in our assessment of the FSC substitute in terms of: export incentive, administrative burden, and revenue outlays and collections.

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[1] This figure includes the foregone taxes on DISC deferred income from the induced exports. A correct revenue foregone calculation would net out tax losses on the induced component.

[2] Not included in the calculation of feedback revenues are avoided costs associated with Federal outlays for various welfare, income maintenance and unemployment programs which would have occurred were it not for the DISC related increases in employment and productivity. Also not included in this calculation are third tier revenues associated with DISC induced income to suppliers. Finally, the so called "ripple effect" would more than double the initial output of DISC, leading to additional tax collections.

FSC: SOME CONCERNS

a. Administrative Burden

The Foreign Sales Corporation ("FSC") proposal's value as an export incentive is wholly dependent upon the ability of American corporations to use the system and to receive in full the intended economic benefits. In this regard there is a major concern that the foreign presence requirements under the administrative pricing mechanisms may create administrative burdens cumbersome and costly enough to discourage export activity for all but the most intrepid. While many of our concerns are subject to clarification through definition and regulation, some fail to recognize the unique business patterns of certain corporate activity.

For example, the meaning of the phrase "maintaining books and records in the foreign office" can be construed to include all books, records, receipts, invoices, cost sheets, payroll, etc. or it could mean a summary of the above. In the former case a major overseas accounting operation would have to be established, in the latter only the formality of a filing.

b. The Commission FSC

As to unique business patterns, a number of corporations engage in foreign sales through a commission agent rather than a subsidiary in the more traditional notion of the word. Typically, the characteristics of a commission style DISC include limited authority to act on behalf of the parent. For example, it is difficult to construct a scenario where a commission agent could satisfy the section 924 requirement that at least 50 percent of the total direct costs of certain activities be attributable to activities performed outside the United States (or the alternative 85 percent foreign activities test). The specified activities are;

- Advertising and sales promotion
- Processing of orders and arranging for delivery
- Transportation
- Transmittal of accounts
- Assumption of credit

In the case of a commission FSC, the qualifying activities should be limited to solicitation (other than advertising) and negotiation.

c. The Factoring Problem

Surprisingly, when introduced S.1804 included language requiring certain foreign trade receivables to be treated as investment in U.S. property under the Internal Revenue Code and therefore subject to U.S. taxation as subpart F income. The effect of this is to deny a substantial portion of contemplated FSC benefits to those companies which finance their own export sales through a foreign factor.

The NAM objects strongly both to the inclusion of this non-DISC/FSC related provision in this legislation, and the effective denial of FSC benefits to companies using the factor method to finance export sales. If enacted, this provision will reduce substantially the profitability of certain export markets, particularly in the area of durable, heavy manufactured goods, such as, farm implements and the like. We recommend that foreign trade receivables continue to be treated as foreign income subject to the benefits on the DISC/FSC programs.

Moreover, it is wholly inequitable that the effective date for this provision should apply retroactively to receivables sold after August 4, 1983, a date well in advance of Congressional considerations of this proposal. Even if the provision were necessary to protect revenue estimates, they should be effective on the same date as other FSC provisions. Because of the devastating amount of tax that would result from the investment in U.S. property provisions described above, taxpayers are presented immediately with the disruption of long standing business practices for financing export sales.

d. The Foreign Presence Tests

To establish a bona fide foreign presence it has been proposed that 50 percent of the direct costs associated with all five of the following items (or alternatively 85 percent of two of the following items) be performed outside the United States by the FSC:

- Advertising and Sales Promotion
- Processing orders and arranging for delivery
- Arranging and paying domestic and foreign transportation costs
- Billing customers and receiving payment
- Assuming credit risk

Failure to satisfy these tests in full presumably disqualifies the FSC for the taxable year in question.

This result seems unjustifiably harsh. What if, after all the good faith effort possible or an adverse audit decision on a clearly arguable point, the FSC accounts for a fraction less than the required percentages for the five (or two) activity tests set out above. As the current DISC rules provide for a taxable distribution to permit qualification if either the qualified receipts or qualified assets test are met. For this reason we suggest that a partial qualification for FSC receipts would be in order.

THE BENEFITS

1. Expanded Private Saving

As presently drafted and discussed above, the FSC proposal gives us cause for some concern that the FSC proposal could manifest itself as an export disincentive vis-a-vis the current DISC program. However, there are some benefits to the proposal which merit review.

First, the administration has proposed that accumulated DISC income will be deemed previously taxed income as of December 31, 1983 and therefore exempt from taxation, as will the untaxed subpart F income of export trading companies. The NAM will oppose in its entirety any legislation which fails to include this provision. Our position is predicated on the certain benefits to be accrued in the United States by the return of foreign profits now stranded abroad. Capital and plant expenditures reasonably expected to be funded from a greatly expanded pool of savings associated with the tax free return of these profits to shareholders will promote fuller domestic employment, increase productive capacity, moderate interest rates and return to the Treasury new revenues through a sustained and robust economic recovery.

2. Repeal of the Incremental Rules

Second, the often cumbersome DISC assets and incremental sales tests will be repealed.

3. International Trade Agenda

Third, by clearing this matter from the GATT agenda, the United States will be free to pursue other pressing trade issues.

CONCLUSION

Whether or not the Foreign Sales Corporation is a suitable replacement for DISC is wholly dependent upon economic benefit. Provided that FSC benefits are not consumed by additional administrative burdens, the FSC and its domestic parent should be able to maintain a competitive posture on pricing in world markets. In this event, export related jobs which have been developed as a direct consequence of the DISC incentive will be maintained and hopefully expanded. Moreover, as export sales grow, the return to the Treasury of new revenues should be substantial.

FOREIGN TAX PRACTICES AFFECTING EXPORTS

July 1982

COLE & CORETTE

FOREIGN TAX PRACTICES AFFECTING EXPORTS*/

Introduction

This report presents information as to how exporters in six foreign countries are taxed. The six countries are France, Germany, Japan, the Netherlands, Sweden, and the United Kingdom. These countries were selected because they are important competitors of the United States, and their laws exemplify various foreign tax rules applicable to exports.

The purpose of this report is to present a realistic picture of how a typical manufacturer in each country is taxed on its export sales, taking into account existing statutory, treaty and case law provisions, administrative practices of foreign tax and currency control authorities, and responses of foreign exporters and their advisors to this landscape. It represents an attempt not to rely so much upon descriptions of statutory provisions and rates as to discuss what practices are actually being pursued. This approach springs from the thought that if one were to analyze the effective rate applied to exports through a DISC, one would be relying upon actual tax return data, not statutory rates adjusted for perceived effects of various tax law provisions. In the absence of tax return data for foreign exporters, however, an attempt to describe actual practices may be at least as informative as a description of statutory provisions.

This report was developed by first compiling information on the foreign statutory, treaty and case law provisions, then engaging correspondent counsel to complete and update this material and, importantly, to comment on how they are advising exporters in the country in question to structure their transactions so as properly to minimize tax liabilities. (A copy of the standard request for information telexed to correspondent counsel is attached hereto.) It should be noted that sometimes foreign exporters will structure their transactions for purposes other than tax, such as for reasons of business flexibility. Also, while compliance is a problem in some countries, illegal or what were judged to be overly aggressive tax plans were not taken into account.

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*/ This study was prepared at the request of The Dow Chemical Company. One or more correspondent counsel were consulted in each of the six subject countries. The views expressed, however, represent those of Cole & Corette and do not necessarily represent those of any other person or group.

Prior studies have addressed the issue of foreign country tax practices applicable to exports. For example, in 1975 Hufbauer examined the taxation of export profits by various industrialized countries by focusing on the costs of capital engaged in export production.*/ He also compared the tax costs of capital for export sales versus domestic sales. Of sixteen countries studied, the U.S. burdened capital employed in export sales more heavily than any other country, with the possible exception of Germany. (If special rules applicable to "development areas," such as West Berlin and border zones, were taken into account, German burdens would fall below U.S. levels; approximately 10% of the Federal Republic of Germany falls within such a development area.) Perhaps more importantly, for the group of sixteen countries the mean differential between burdens on export sales and burdens on domestic sales was 24 points, whereas for the United States this differential amounted to only 15 points. These facts indicate that other countries typically foster exports over domestic production to a greater degree than does the United States. This paper was based on statutory rates and provisions. Certain arbitrary assumptions, of necessity, were incorporated.

Also, in July of 1975, a comprehensive study entitled "Comparison With Practices of Foreign Countries" was appended to testimony presented to the Senate Budget Committee.**/ This study described, among other things, the tax and non-tax export incentives of six foreign countries: Belgium, France, Germany, the Netherlands, Japan, and the United Kingdom. It will be noted that this study predates certain significant changes in foreign law, such as the corporate tax law changes in Germany, and that it was not the intention of its authors to depict the practices followed by foreign exporters so much as to outline the various statutory rules.

In 1977, the National Planning Association published a report on "Income Taxation and Competitiveness in the United States, West Germany, France, the United Kingdom, and Japan" by Horst. The following table summarizes the study's findings:

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*/ Hufbauer, Taxation of Export Profits, 28 NAT'L TAX J. 43 (1975).

**/ Task Force on Tax Policy and Tax Expenditures of the Senate Comm. on the Budget, "DISC: An Evaluation of the Costs and Benefits," 94th Cong., 1st Sess., p. 114 (Comm. Print 1975) (Appendix C, Testimony of Special Committee for U.S. Exports [July 23, 1975]). This study was updated by its authors and made current as of January 15, 1976.

TABLE: Summary of Estimates of Effective Rates of Taxation on Domestic, Export and Foreign Investment Income for Corporations Domiciled in the United States, West Germany, France, the United Kingdom and Japan

	Effective Rate of Taxation on:	
Country	Domestic Income*/	Export Income*/
United States	36.7%	27.4%
West Germany	39.7%	39.7%
France	34.3%	8.7%
United Kingdom	17.8%	12.2%
Japan	29.2%	17.9%

Notes:
*/Except in the case of the U.S., the rate assumes that a corporation pays a grossed up dividend equal to its retained earnings. A higher dividend payout rate would result in a lower effective tax rate

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The author pointed out, however, that the above table was necessarily simplified, and that it focused only on income taxes. Other direct taxes, such as individual income taxes and social security taxes, consumption taxes, and more direct subsidies are not taken into account.

The National Planning Association published a second significant report in January 1982, called "Taxes, Subsidies and Competitiveness Internationally" by Mutti. This study analyzes the competitive effects of aggregate tax burdens and subsidies in six foreign countries (Canada, France, Germany, Italy, Japan and the United Kingdom) and the United States. In summary, the study found as follows:

> At the aggregate level, U.S. tax burdens, as measured in terms of shares of gross domestic product, are moderate compared to the other countries studied. Only in Japan do taxes account for a smaller share of Gross Domestic Product. However, allowing for government expenditures that assist or subsidize production gives a different picture of the net effect of government fiscal intervention on international competitiveness. By subtracting the benefits afforded by various subsidized expenditure programs, net tax burden figures are derived which suggest that the result of government fiscal intervention is to confront U.S. producers with relatively higher costs of labor and capital. Other things equal, this tends to discourage investment, employment and production in the United States.

As with the Horst study, the Mutti study was based upon statutory rates and provisions. In order to develop aggregate figures, a number of somewhat arbitrary assumptions had to be made. Also, no comparison was made with the income tax revenue pick-up anticipated under these analyses versus the revenue pick-up actually achieved. In fact, such a comparison probably could not be made because of the diversity of revenue reporting methods. Likewise, a comparison of anticipated effective rates with actual taxes paid by companies would be unreliable due to the differences in accounting methods; and it is a well-recognized fact that in most countries the publicly-held and nationalized companies are much less aggressive in their tax planning than closely-held, private companies.

The effects of "consumption type" value added taxes that "zero rate" exports and are applied on the destination-country principle are not debated in this study. In the U.S., it is often said that such taxes act to promote exports. Europeans point out, however, that while the U.S. does not have a federal level value added tax, the states have sales taxes that are not imposed on exports. In response, it is pointed out that sales taxes do not comprise as great a percentage of the total burden on exports as do value added taxes. And so the debate goes.

SUMMARY

The tax practices of six foreign countries have been examined to determine how they affect exporters in each country. Only the tax rules were reviewed. No attempt was made to examine non-tax programs such as export insurance and export financing programs.

It is generally believed if all forms of subsidization were analyzed -- non-tax as well as tax -- it would be found that, overall, other countries subsidize their exports to a greater degree than the U.S. Looking at tax rules alone, however, it might be assumed, based on descriptions of statutory provisions and rates, that certain other countries do not foster export performance to a remarkable degree. In fact, this is not the case. When actual foreign practices are drawn into the light, it is evident that every country, in one fashion or another, encourages exports by means of the structure and application of its tax laws. Each of the countries examined encourages exports in this way to a greater degree than the U.S. Also, with respect to each, a close examination of actual practices leads to the conclusion that taxation of exports is generally at an even lower rate than heretofore supposed.

Countries foster exports with tax laws and practices in widely varying ways. As a general rule, the number of overt "subsidies" in domestic tax rules has been reduced in recent years, but a number still remain. It is more common for favorable provisions to appear as foreign tax provisions in a country's internal tax laws. The territorial tax systems used by the Netherlands and France are obvious examples. Omissions in the coverage-tightening provisions of subpart F-type laws in the case of Japan and Germany are less obvious examples. One frequently encountered aspect is an approach to pricing rules that permits an allocation out of a large percentage of export profits. Based on the most recent developments, it would be an overstatement to say that foreign countries are moving in the direction of a more stringent enforcement of arm's-length pricing rules. In 1979, the OECD Council adopted a recommendation on the determination of transfer prices between associate enterprises. To date only one country, Italy, has enacted new provisions or finally promulgated new rules tightening enforcement in this area. Another aspect which is often overlooked is the treatment of export expenses. There are, in fact, two principal variables in intercompany pricing rules: supplier markup and supplier cost. It is obvious that if a markup of 8% over supplier's cost is required as a result of statutory provisions, regulations, or audit practices, less foreign source income will be available for low-tax treatment than if a 4% markup were allowed. Less obvious but more important is the effect of allowing a low figure for the supplier's cost -- usually by permitting the supplier to avoid allocating overhead cost to exports as an expense. No country examined appears to be actively pursuing this point.

As stated previously, each of the subject countries has its own unique approach to taxing exports. In each country, moreover, exporters are able properly to reduce their tax liability. While U.S. companies similarly are able to increase their DISC benefits or mitigate the effects of subpart F, it is apparent that foreign exporters can benefit from tax planning to an even greater degree.

- Under the French territorial system, income of a foreign branch is generally not subject to French taxation. Alternatively, where foreign subsidiaries are used, a two-tiered dividend system permits the retention of untaxed foreign source profits while allowing the distribution of tax credit-bearing domestic profits to French shareholders.

- There are a number of tax-free reserves that can be taken by a German parent with respect to its foreign subsidiary in harmony with a two-tiered dividend system similar to the French system, permitting the retention of untaxed foreign source profits while allowing the distribution of tax credit-bearing domestic profits to German shareholders.

- A Japanese corporation, by making use of a combination of certain domestic reserves, tax treaty rules and foreign law can, by using a Singapore trading subsidiary, avoid any tax on both the subsidiary's income and on dividends paid to the parent, as well as obtain a domestic deduction for developing an overseas market.

- In the Netherlands, the profits of foreign branches are generally exempt from Dutch taxes either by treaty or unilateral measures, while net losses of such branches often are deductible domestically. Where subsidiaries are used, income of a foreign subsidiary is not subject to Dutch tax nor are dividends received or capital gains arising from the foreign subsidiary generally subject to Dutch taxes. Also, offshore operations in the Netherlands Antilles, which are a part of the Kingdom of the Netherlands, are encouraged.

In Sweden, in addition to certain tax-free reserves for development of export markets and export credit allowances, there are a substantial number of favorable tax treaties under which Sweden has agreed to forego taxation of income of a branch of a Swedish corporation located in another state but will still allow the deduction domestically of the branch's losses.

A United Kingdom corporation can generally accumulate profits outside of the U.K. indefinitely. Using certain treaty countries, a U.K. corporation can receive domestic tax credits for taxes that it will not pay, because of a foreign tax holiday, under the "tax sparing" provision of the treaty.

FRANCE

I. Domestic Taxation

French companies are liable for tax on net profits from operations in France at a rate of 50%, with a minimum tax of 3,000 FF. Current overall deficits may be carried forward for five years. As a rule, subsidiaries of French companies are treated for purposes of taxation as separate entities and not consolidated. Under certain conditions, however, a parent and subsidiary may elect to consolidate their returns for purposes of the company tax. For such an election to be available, there must be prior approval from the Minister, both the parent and the subsidiary must be French, and the parent must own, either directly or indirectly, 95% of the subsidiary. Companies are considered French residents on the basis of their registered seat of business (unless this is fictitious -- in which case residence is where central control and management lie).

In computing taxable profit, French companies are permitted a variety of adjustments in addition to normal deductions for business expenses. Companies are allowed depreciation in accordance with the general practice in a particular industry. Both straight-line and declining balance methods are acceptable. Accelerated depreciation is permitted under certain circumstances. Capital gains are short-term on assets held for less than two years. While taxed at ordinary rates, short-term capital gains are included in income over a three year period, one-third in each year. Half of the amount invested for the creation or expansion of industrial, hotel, and fishing businesses in the Overseas Departments, for example, Martinique and Guadeloupe, is currently allowed as a deduction.

Other noteworthy features of French domestic taxation include investment incentives for new or expanding companies. In 1982 and 1983, small enterprises are exempt from tax on one-half of all profits, whether retained or distributed. Also, there are special-purpose reserves which are excluded from taxable profits unless and until they are no longer required for the specified purposes or are withdrawn or otherwise liquidated. The following reserves are available: reserve for bad debts; reserve for depreciation of raw materials and investments and against other risks and liabilities of business; reserves for maintenance of essential stocks and raw materials, or to cover price fluctuations of raw materials imported for processing; and reserves for research and exploration by mining and extractive industries operating in France or in the French Union (the latter includes African states which were previously French colonies). Newly formed corporations and those increasing their capital between January 1, 1977, and December 31, 1982, may deduct dividends paid in the following seven years from taxable income, up to 7 1/2% of cash subscriptions made during that period.

French goods and services are subject to a VAT of 17.6%, although luxury goods (including automobiles) are subject to VAT at a rate of 33 1/3%.

In general, if a French company owns 10% or more of another company, distributions received from such a company are exempt from taxation to the distributee. In practice, 95% of the distribution is exempt, with the tax law assuming that the other 5% is attributable to the distributee's management expenses with respect to the distribution. If the distributee can show that actual expenses with respect to the distribution are less, the exemption can be increased. It appears that distributees do take advantage of this provision, and it is estimated that generally 3% of such dividends are actually treated as non-exempt. The minimum holding of 10% may be disregarded where the interest is held in connection with an officially approved scheme benefitting the economy, or where the participation interest is in loan associations set up to finance investment in certain sectors of the economy.

Distributees of dividends always receive a tax credit (avoir fiscal) equal to 50% of the net dividends received. Distributees report as income the grossed-up dividend. If the profits from which the distribution is made have been subject to full company tax, there is no withholding by the distributing company. With respect to profits that are exempt, such as foreign source profits, a prepayment tax (precompte mobilier) equal to the tax credit amount is levied at the time of distribution.

A variation of the above is applied with respect to resident individuals except that any unused portion of the tax credit is refundable or creditable against his other tax liability. If the individual's marginal tax rate is 33 1/3% or less, he will pay no net tax on the dividend.

Finally, if the distribution is based on profits exempt from company tax, the distributing company must withold the prepayment tax from the distribution at a rate of 33 1/3%. However, the prepayment tax is not paid where the distribution is with respect to dividends received from a French subsidiary. This is because the French subsidiary's profits, having been fully taxed, carry with them the usual tax credit upon distribution to the parent. This credit covers the prepayment tax due on subsequent distribution by the parent. In contrast, exempt dividends received from foreign subsidiaries do not carry with them the tax credit, and thus the prepayment tax will be due on distribution by the French parent of dividends based on foreign subsidiary distributions.

Nonresidents are liable for French taxes on profits arising from operations in France. Any French profits earned by a nonresident company are deemed fully distributed and liable to a prepayment tax of 25% in addition to the company tax of 50%. If the shareholders are otherwise liable for French taxes, the 25% prepayment tax is available to them as a credit against their French tax liability. The prepayment tax is non-refundable to nonresidents, but may be refundable under double taxation agreements.

II. Foreign Taxation

A. Export Incentives

There are several different provisions in French tax law directed specifically at encouraging exports.

1. Option to be Taxed on Foreign Source Income

Companies with foreign source income may elect to include such income in calculating their overall French tax liability. This election must receive prior approval of the Minister of Finance. There are two alternatives available to a company which desires to make this election. Under the first alternative, the benefice mondial, the French company may combine its domestic income and its foreign income from direct operations abroad, such as foreign branches or income from a complete commercial cycle outside of France. Under the second alternative, the benefice consolide, the French company may include indirect income from operations which are under the control of the French company. This latter alternative allows consolidation of the operations of a foreign-based subsidiary of a French company with the parent's domestic operations and foreign branch operations. The French parent must own at least 50% of the voting rights in the subsidiary to be considered in control.

The election is made through negotiations with the Ministry of Finance for an agreed-upon period, usually five years, and is irrevocable for that period. It appears that these two alternatives were specially designed for French companies with important foreign interests, and particularly those engaged in overseas oil and gas exploration.

It appears that this election has not been frequently sought or allowed; as of 1976, approximately twenty companies had been permitted to elect the benefice mondial, while approval for the benefice consolide had almost never been given.[*] The advantage of this election is to permit losses from overseas operations to be offset against French domestic profits. An additional advantage is that dividends distributed out of foreign profits are not subject to the prepayment tax.

If either of these elections is made, the French company is allowed a tax credit for taxes paid to foreign governments by the foreign operation. This credit is limited to the amount of French tax that would have been due on the foreign income if taxed under French rules. The amount of any excess tax paid is allowed either as a deduction in the following year or as a credit over a five-year period. Otherwise, income and deductions based on foreign operations is generally computed according to the rules applicable to domestic operations.

2. Accelerated Depreciation

Accelerated depreciation is available on assets belonging to exporting enterprises.

3. Export Credit Risk Reserve

A company may set up a tax-free reserve to cover special risks arising from medium-term credits granted with respect to sales effected or work performed abroad. The amount that may be reserved is 15% of taxable profits or 2% of the relevant credits outstanding, whichever is greater. The total amount of the reserve is limited to no more than 5% of the total amount of medium-term credits outstanding.

4. Commercial Export Activities Reserve

If a French company establishes an overseas sales office, research, study, or information center, either through a foreign branch office or a 10%-owned entity (such as a foreign subsidiary), it may create a tax-free reserve. The amount of this reserve differs, depending on whether the investment is in an EEC country or elsewhere. In an EEC country, the reserve is limited to the lower of either (a) losses connected with such activities incurred during the first five years of operation or (b) the capital invested in the foreign branch or other entity. In non-EEC countries, the reserve is limited to an amount equal to the capital invested in the activities during the first five years of operations. Countries considered tax havens are excluded for purposes of this reserve. To set up this reserve requires prior authorization from the Minister of Finance, and this authorization is denied if the activities do not lead to an increased export of goods manufactured in France. Authorization is deemed to be given, however, if not refused within two months. The reserve must be restored to taxable income over a five year period beginning in the sixth year following the investment.

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[*] Staff of House Comm. on Int'l Relations, 95th Cong., 2d Sess., Export Stimulation Programs in the Major Industrial Countries 124-125 (Comm. Print 1978).

5. Industrial Investment Overseas Reserve

French companies may establish a tax-free reserve with respect to industrial investments, such as manufacturing or processing, in certain foreign countries listed by the Minister of Finance. This list is comprised of developing countries. The amount of the reserve is limited to one-half the capital invested in the first five years of operation. The investment may be made through either a foreign branch of the French company or a 10%-owned subsidiary. As with the reserve for commercial export activities, the company must receive authorization from the Minister of Finance, and the reserve must be returned to taxable income over a five-year period beginning in the sixth year after the investment.

6. Value Added Tax

Goods and services destined for export are exempt from VAT, and may be purchased in France VAT-free or subject to a refund of VAT. The exemption is effected by means of an offset against other VAT liabilities in the case of small exporters and by means of a refund in the case of larger exporters. Refunds typically lag three months behind the export, but advance payment can be achieved by exporters that can show a regular quota of refunds.

7. Joint Export Programs

When small or medium size businesses create joint ventures to improve business, they can negotiate a tax agreement with the Minister of Finance which allows them both tax and nontax advantages. These provisions are made explicitly applicable to joint export programs. The following tax advantages are currently available: (a) the shareholders' investment in the stock of the new company may be fully deductible in the year made; (b) the company may depreciate its assets as usual; and (c) capital gains on the sale of shares in the company may be reinvested without taxation within one year in shares of a similar joint venture. However, the company is not eligible to deduct its expenses for the establishment of a foreign office.

B. Taxation of Foreign Income

The French tax system is based on the concept of territoriality. As a general rule, income generated by foreign operations is not subject to French tax. Foreign source income is defined as income that is either (1) related to a permanent establishment situated outside France; or (2) derived from operations abroad of dependent agents; or (3) derived from operations which constitute a complete commercial cycle (cycle commercial complet) outside of France. While there is no statutory definition of a cycle commercial complet, and taxpayers must rely upon case law, it is fair to say that something far short of manufacturing abroad will suffice to bring the activity within the rule; in fact, the concept commonly applies to purchase and resale activities. In practice, this means that profits generated by exports sold through a foreign branch or foreign subsidiary are commonly excluded from French taxation. In conformity with the principle of territoriality, losses and expenses arising from foreign operations are generally excluded as deductions from the taxable profits of a French company.

1. Unless a French company elects to be taxed on its worldwide or consolidated income, the principle of territoriality precludes French tax on the income of foreign branches or subsidiaries. There is no requirement that the foreign source income be subject to taxation in the source country.

2. Dividends received by a French company from a foreign company are exempt from company tax if the French company holds a 10% or greater interest. If the dividend exemption does not apply, the dividend is taxable net of foreign income and withholding taxes imposed.

3. As noted, foreign source income from either a branch or subsidiary of a French company is not subject to French company tax. If this income is subsequently distributed to shareholders the company must pay the prepayment tax. This may be avoided, however, if the French company does not distribute the foreign source income. French companies can designate the source of the profits from which a dividend is paid. Thus, if a French company earns half its profits from its own domestic operations which are fully taxed, or from dividends distributed by a domestic

manufacturing subsidiary, and earns the other half of its profits from foreign operations, such as a foreign sales branch or subsidiary, it can distribute dividends from the fully-taxed half of the profits and retain the other half tax-free indefinitely. It appears, generally, that French companies distribute half their current profits to shareholders.

4. Intercompany Pricing Rules -- Article 57 of the Code General des Impots

Related companies are required to use arm's-length pricing in intercompany transactions. Article 57 of the French Code General des Impots (C.G.I.) permits tax authorities to reallocate income and deductions where an abnormal advantage in prices has been granted by one company to a related company. The concept of related companies is not well defined, but includes companies sharing mutual interests whether by reason of legal ties or on the basis of fact. The 1982 Finance Act shifted the burden to the taxpayer as to whether two companies are related, by presuming that they are related if an abnormal advantage is found. The taxpayer may rebut this presumption. The tax authorities, however, still carry the burden of proving the existence of the abnormal advantage. The methods for computing arm's-length prices -- and thus, abnormal advantage -- are not well defined. Instead, so-called empirical approaches are followed, e.g., the practice within an industry as to transactions between unrelated parties. However, a 50/50 division of profits is often used as a starting point.

Despite this provision, in the past and perhaps to a lesser extent today abnormal pricing practices may be permitted under certain circumstances. In the case of French manufacturing companies selling to overseas subsidiaries, for example, advantageous transfer prices may be permitted if the understatement of price can be deemed a long-term investment made in the interest of the French company. This exception may be permitted for the purpose of promoting exports and to aid in the establishment of enterprises intended to sell French products abroad. The principle of arm's-length pricing also may not apply if the French company reduces its profit margins for competitive reasons and can prove it does not intend to accumulate excessive profits abroad.

It should be noted that present practice may lead not only to a reallocation of profits but also to imposition of severe penalties for illegal transfer of capital (up to 500% of the amount in question); and that the presence of these penalties may influence the settlement of disputes concerning transfers.

Where a French manufacturing company purchases components from a related company abroad, the purchase price is more carefully scrutinized. In addition, where the French company both pays a royalty for know-how from a related company and also pays a high purchase price for components on the basis of this know-how, the tax authorities may not adjust the purchase price but will disallow the royalty payment as a deduction to the French company.

In financial transactions, the authorities consider an impermissible advantage to have been granted whenever royalties are deemed excessive or loans are granted without interest between related companies. Where a French company pays royalties with respect to patents, trademarks, etc., or interest on bonds to a non-French resident these are normally deductible expenses. In the case of royalties, they must have been based on patents or know-how actually used to manufacture the product and the French company must not have been involved in the research and development process.

It is believed that, at present, many French companies are principally interested in accumulating funds outside of France for purposes of business flexibility -- so as to be able to act on business opportunities without inordinate delay caused by the necessity of obtaining government approval of investments. This situation has led some companies to enter into artificially low-priced transactions with unrelated parties in order to substantiate similarly low-priced transactions with related foreign subsidiaries.

5. Article 238A

This provision of the French tax law prevents deductions of payments to a foreign entity, whether or not that entity is related, if the recipient resides in a tax haven. A tax haven is defined as a foreign state or territory which applies a "privileged tax status." This phrase applies to any country where the company tax is two-thirds or less of what French tax would be. The tax authorities have issued a list of tax havens for purposes of Article 238A, but this list is nonexclusive. The tax authorities draw up the list on the basis of what they believe is the effective tax rate in another country, based on its statutory tax structure. Of course, countries which impose no tax on companies, or which do not tax profits from foreign sources, are automatically included on the list. Thus a number of different types of payments, including interest, royalties, management fees, etc., are nondeductible if made to an entity in a tax haven. The burden is on the taxpayer to show that the payments were actually made and that the payments were reasonable and relate to actual operations of the French company. Nondeductible amounts are added to taxable income. In addition, they are treated as dividend payments to nonresidents, and so the prepayment tax of 25% is levied as an additional tax on the disallowed deductions.

6. Article 70

Article 70 of the C.G.I. provides that a French parent company may be taxed on its foreign subsidiary's income if that subsidiary is located in a tax haven as defined in Article 238A. The French parent's share (proportional to its interest in the subsidiary) is imputed to the French parent and subject to the company tax. Losses will not be imputed. For Article 70 to apply, the French parent must own, directly or indirectly, at least 25% of the shares of the tax haven subsidiary. Attribution and constructive ownership rules are not presently described in any decrees. Credit is allowed against French tax for taxes actually paid by the subsidiary.

The provisions of Article 70 are not applicable, however, if the French parent can show that the foreign subsidiary's operations do not have, as their main effect, the localization of profits in the tax haven. This condition is deemed met if (1) the foreign subsidiary's main activity is a genuine industrial or commercial activity and (2) most of its transactions are either in the foreign country concerned or with businesses which it does not control and which are not controlled by the same third-party company.

This provision is new to the French tax code (it was enacted as part of the 1981 Finance Act), and it appears that its effect may be somewhat mitigated by several considerations. First, subsequent redistributions of the imputed profits by the French parent are not subject to the prepayment tax, as would be the case were the subsidiary located in a non-tax haven. In addition, the interest requirement of 25% leaves a "window" between 10% ownership and 25% ownership. A French parent owning an interest within that range would not be subject to Article 70 and yet would be entitled to the dividends received exemption outlined previously.

In fairness, it should also be pointed out that the degree of enforcement of the French tax and currency control rules varies according to the Government in power and perhaps also the prevailing economic conditions. Under the present Government, these rules are being enforced to an unprecedented degree. Individuals and companies found to be in violation of these provisions are sometimes criticized as having a "bad attitude" toward the laws and their country.

7. Special Tax Amnesty

Recently the French government declared an amnesty on capital abroad acquired in an "irregular" manner. Such capital would be those assets acquired abroad which were financed with undeclared income or with money illegally exported. These assets may include money, gold, securities, real property or other property. Under the provisions of the amnesty, a French taxpayer may repatriate the capital, no questions asked, upon a payment of 25% to the tax authorities. Normally these amounts would be subject to a 500% penalty. The amnesty ran from January 1, 1982, through June 1, 1982, for real property, and through March 1, 1982, for other assets.

8. Export Taxation Example

To illustrate French practices, one might consider the French exporter making sales into the Far East utilizing a Hong Kong sales subsidiary subject to a Hong Kong statutory corporate tax rate of 17%. Only a minor amount of its profit is ever subject to additional French taxation upon repatriation. Perhaps about a third of such profit might typically be retained for working capital. The balance can be repatriated to France. In France, as foreign source income, the repatriated income would not be taxed under territorial rules. Only approximately 3% of the income contributes to taxable income due to the presumed attribution of domestic expenses to the foreign dividends. Should it be necessary to then distribute this foreign source income to shareholders, the prepayment tax, which is the equivalent of the domestic corporate tax, is imposed on the corporation. However, companies generally distribute less than half of their earnings, and when doing so, French companies will distribute high-tax domestic source income rather than foreign source income. No earnings and profits "stacking" rules prevent this maneuver. Assuming that the French parent had adequate domestic source profits for distribution purposes, French taxes add negligibly to the taxes in the base country (Hong Kong), making the combined tax burden on the foreign source income no more than 18%. There are only two limitations on how much of the combined profits of the parent and the subsidiary could benefit from this low tax -- intercompany pricing rules and shareholder demand for distributions. Experience indicates French companies distribute half their profits. Thus, if a French export manufacturer and its Hong Kong subsidiary split combined profits 50/50, there would be fully-taxed profits for distribution and low-tax profits for retained earnings for the parent. To the extent that (a) shareholders wished lower distributions and (b) a larger proportion of the profits could be allocated to the subsidiary, the tax benefit for the parent would be increased.

C. Tax Treaties

France has an extensive system of bilateral tax agreements with over 56 countries.

ERRATA

1. Page 8 (last paragraph):

   The tax exemption for small enterprises applies only to newly formed enterprises, not more than 50% of the voting rights of which may be owned directly or indirectly by other companies. The exemption applies to the year in which the enterprise was created and the following 4 years.

2. Page 9 (first full paragraph):

   The rate of 17.6% should be corrected to read 18.6% in accordance with a recent increase in VAT rates.

3. Page 11, paragraph 2, "Accelerated Depreciation":

   Delete. Accelerated depreciation is no longer available on assets belonging to exporting enterprises.

4. Page 11, paragraph 3, "Export Credit Risk Reserve":

   The export credit risk reserve has been modified. The second sentence of this paragraph should read "The amount that may be reserved is 10% of the relevant credits outstanding." The last sentence of the paragraph should be deleted.

5. Page 12, paragraph 7, "Joint Export Programs".

   Delete.

FEDERAL REPUBLIC OF GERMANY (WEST GERMANY)

I. Domestic Taxation

German corporations are subject to a corporation tax, a property tax, and a Business Tax (discussed below). In general, German corporation tax is imposed on worldwide income. A rate of 56% is charged on retained profits, and a 36% rate is charged on distributed profits. The corporation tax is imposed on a company which is a resident of Germany, determined by reference to its incorporation in Germany or to the fact that the head office or management of the corporation occurs in Germany. Taxable income is generally computed on the basis of a net worth comparison of the balance sheet of the corporation for two successive years. The resulting net worth is adjusted for capital investments and withdrawals that are made during the taxable year. If the current year shows a loss, such a loss may be carried back two years up to a limit of DM 5,000,000. Any excess over this figure may be carried forward for the next five years. Property tax is imposed at a rate of 0.7% on net assets and is not deductible.

Depreciation for movable assets with a life of greater than one year is allowed on either a straight line or declining balance method. Buildings are generally depreciated on by a straight line method over 50 years. Relative freedom from inflation has had the effect of safeguarding the depreciation writeoffs from devaluation. In addition, there are special accelerated depreciation provisions for industries located in West Berlin or in certain border areas.

Taxes on the corporation itself, other than the corporate tax, are also deductible. Gains realized by a business enterprise from the sale of capital assets, including shares in a company, are normally taxable as ordinary income. However, under certain circumstances if assets sold are replaced, the gain realized on the sale of the asset is exempt.

Tax-free reserves may be established to account for price increases of raw materials and stock in trade which are fungible goods, where replacement costs have increased more than 10% within the accounting year. Such reserves may be kept for up to 6 years, and then must be returned to taxable income.

Goods and services are subject to a value added tax of 13%. There are special value added tax concessions, however, on goods manufactured in Berlin and shipped to the Federal Republic. These result in a substantially lower VAT being imposed on goods manufactured in West Berlin.

Normal tax rates are reduced by 30% for taxpayers who are resident in West Berlin with respect to income arising there, or for non-Berlin residents on income from a business in West Berlin which employs at least 25 persons.

Profits distributed by way of a dividend are subject to a 36% corporate tax rate. If the profit has been taxed in a prior year at the higher retained profits rate of 56%, the 20% excess will as a rule be credited against future taxes. Dividends distributed are, in addition, subject to a capital yields tax of 25% of the net dividend. While the capital yields tax is paid by the corporation making the distribution, it is essentially a withholding tax.

The shareholder receiving the dividend uses as taxable income a net dividend grossed up by the 36% corporation tax paid. However, the shareholder is allowed a tax credit in the amount of the corporation tax paid plus the capital yields tax. Both individual and corporate distributees are entitled to a refund of this tax credit if it is in excess of their tax liability. Under this complete integration system, no dollar of corporate income is subject to tax at both the corporate and shareholder levels. Because the 36% corporate tax on distributed dividends can be used by the distributee as a credit against his own tax liability, the effective tax on the corporation with respect to profits distributed is zero if the corporate tax is viewed as merely an advance payment of the shareholder's tax.

Under German corporate tax law, distributions are deemed to be made out of profits in the following order:

1. Retained profits (that is, profits accumulated in previous years which have been subject to the 56% corporate tax on retained profits);
2. Current profits;
3. Profits not subject to tax.

Companies whose head office and place of incorporation are in West Berlin or who employ 25 people there are eligible for a special tax rebate in respect of business income arising there. The rebate is 22 1/2% of the tax on West Berlin income, except where the income is a result of distributions from other companies in Germany. In the latter case, the rebate is only 10%.

[1] In general, nonresidents are subject to tax on all income arising in the Federal Republic; they are, however, ineligible for a variety of the deductions normally allowed to a German resident.

The Business Tax is a tax levied by local authorities. It has two elements: a tax on the capital of the business and a tax on the profits of the business. The actual rate of tax imposed is established by local authorities. The tax rate on capital generally varies from .5% to .9%. The tax rate on profits tends to vary between 12% and 22%. The higher rates tend to be imposed by localities in highly industrialized areas.

II. Foreign Taxation

A. Export Incentives

1. A tax-free reserve may be created for profits arising from the transfer of a depreciable business asset to a company, business, or permanent establishment overseas which is engaged in industry, transport, mining, or agriculture. This transfer must be in conjunction with a new investment by the German taxpayer in the overseas company, business, or permanent establishment, or where the taxpayer already owns the overseas company or establishment. This reserve is not available if the German taxpayer has created a reserve under the special rules for investments in underdeveloped countries. This reserve must be returned to income in equal, 20% installments beginning in the fifth year after the creation of the reserve. The reserve must be returned earlier if the foreign investment or the business assets are disposed of. In the case of business assets, no early recovery is required if the disposal of the business asset is counterbalanced by a transfer of a new asset.

2. Tax-free reserves for losses incurred by a foreign subsidiary are permitted. A German company may create a tax-free reserve with respect to documented losses which are incurred by a foreign company in which the German company holds an interest of at least 50%. Only a 25% interest is necessary for an investment in a company located in an underdeveloped country. However, at least a 5% interest must have been acquired after 1968. This reserve may be maintained in the year of its creation and for the four following years, and then returned to profits. The reserve is returned to profits earlier if a profit is made; or upon disposal of the investment; or if the German company can produce no documented evidence of the loss; or under certain other circumstances.

The amount of the reserve is the share of the foreign company's losses allocable to its ownership interest in the foreign subsidiary. The upper limit for this reserve is the total value of the shares acquired by the German company as valued for tax purposes.

3. A tax-free reserve is provided for investments in underdeveloped countries. This reserve may be deducted from assessable profits, and under a recent amendment to the law the deduction is permissible even if it creates or increases an operating loss in the German business. The amount of the reserve permitted depends upon the underdeveloped country in which the investment takes place. German tax authorities have divided underdeveloped countries into two groups. Countries in the first group are poorer than countries in the second group. For countries in the first group, 100% of the investment may be placed in the tax-free reserve. For countries in the second group, 40% of the investment may be placed in the reserve. Beginning with the sixth year after the investment, there is a gradual return to income of profits of the reserve. The rate at which the return takes place also depends upon the underdeveloped country in which the investment takes place. For the countries in group one, 1/12 of the investment reserve is returned each year. For countries in group two, 1/6 of the investment reserve is returned each year. With respect to group two countries, if the investment is particularly valuable in the context of energy or raw material policy, then the reserve may equal 60% of the investment, and the reserve is returned to income at the rate of 1/12 of the investment reserve per annum.

To qualify for the special provisions for investment in underdeveloped countries, the investment must be connected with either the acquisition of shares in a company in an underdeveloped country at the time of its creation or of a substantial increase in its capital. A German taxpayer may also qualify for these special provisions if the investment is by way of loans under certain conditions or if it involves the contribution of business assets to an overseas establishment owned by the taxpayer, provided that in either case it is connected with the foundation of the business or a substantial expansion of such business. In addition, the enterprise in the underdeveloped country must be engaged in the manufacture or distribution of goods, agriculture, forestry, mining, or the provision of commercial activities other than tourism, leasing, or licensing. Indirect investments through holding companies in underdeveloped countries also qualify under certain conditions, the most important of which is that the taxpayer must own more than 25% of the holding company.

4. Goods and services destined for export are exempt from the value-added tax, and a refund to the company is available.

5. Business or trade tax. There is unilateral relief provided by German tax law with respect to the business or trade tax in the case of certain foreign source income. The following are excluded from the basis of the profit element of the business or trade tax:

a. income from foreign permanent establishments;

b. distributions from a 25%-owned foreign company, if the company is engaged in active business; and

c. profit attributable to a place of business outside Germany.

Additionally, relief is usually provided under German double taxation agreements.

6. Under the deemed distribution rule as outlined above, dividends distributed by German companies are considered to have come first, from retained profits subject to the full corporate tax of 56%; second, from current profits; and, third, from exempt profits. Thus, if a German corporation distributes dividends which total no more than its retained profits and its current domestic profits, exempt foreign source profits may be retained and used by the company without being subject to any tax whatsoever. This allocation rule has led major German companies to follow a policy of proper "income mix". Under this policy, the profit needed for distribution should be covered by fully taxed income from German sources so that exempt foreign source income can be held in the retained earnings account. As of 1980, it appeared that only one major listed German company has been forced to use exempt foreign source income for distributions. As a result of this, the value of foreign source income to a company will vary significantly depending on its income mix. A further consequence is that intercompany pricing policy has been influenced by the need to retain the correct income mix.*/. Normally, however, double taxation treaties provide for a deduction from dividends at the source. There is one notable exception, however. Dividends received by German companies from French companies are not subject to the prepayment tax of 25% normally imposed on dividends distributed by French companies to nonresidents. Because French company tax law in effect exempts foreign source income from taxation, it is useful for a Germany company to conduct foreign business by way of a French company.

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*/ H. AULT & A. RADLER, THE GERMAN CORPORATION TAX LAW WITH 1980 AMENDMENTS 37 (2nd rev. ed. 1980).

B. Taxation of Foreign Income

Under German corporate tax law, a German company is taxed on its worldwide income. Income from a foreign branch, computed under German rules, is added to the German company's taxable income. Any foreign tax paid is credited against the proportion of total German tax payable which is attributable to the foreign source income. This, however, applies where there is no tax relief through a double taxation agreement. Foreign taxes paid, if not eligible for the tax credit, are treated as deductible expenses. International merchant shippers may, as an alternative, claim a reduced rate of tax in respect to foreign profits. This alternative, available only to shippers, allows 80% of the total foreign profits to be subject to taxation at half the average rate for the total taxable income of the company. The remaining 20% is taxed at normal rates.

Foreign source income is normally exempt from German corporate tax where a double taxation agreement exists. In addition, German tax law provides special exemptions for income derived from investments in underdeveloped countries. Because Germany has double taxation agreements with virtually all of the major industrial countries, and most of the balance of the countries in the world fall into the underdeveloped category, most foreign source income is effectively exempt from German taxation.

1. Capital gains

Where a German taxpayer sells shares in a capital company which he has held for six years and reinvests these in a foreign company, business, or permanent establishment, 80% of the capital gain may be deferred (by reducing the basis of the interest in the foreign business by this amount), if the business is in the field of industry, mining, agriculture or transport. The acquisition of the new shares must be approved by the Minister of Economics.

Unrealized foreign currency gains are not taxed on a current basis whereas unrealized foreign currency losses are currently deductible.

2. The German parent corporation can claim relief for foreign taxes paid by a foreign subsidiary on the subsidiary's profits to the extent the profits are distributed to the German parent as dividends. To qualify for this relief, the parent must own 25% of the subsidiary's stated capital. The relief is granted by way of a credit against the corporate

tax chargeable on the dividends in the following circumstances:

a. Where the dividend is from a trading subsidiary or a holding subsidiary which controls a trading subsidiary;

b. If the subsidiary is in an underdeveloped country, as long as the underdeveloped country investment relief is in force;

c. Where a trading sub-subsidiary is owned through other subsidiaries, but 25% of the sub-subsidiary must be held indirectly by the German parent.

There is a special provision for subsidiaries in the second category, that is, subsidiaries in underdeveloped countries. In this case, the amount of the credit allowed is always equal to the German corporate tax, regardless of the actual tax imposed in the underdeveloped country. It follows that dividends from underdeveloped countries are in effect exempt.

3. Generally, foreign source income is exempt under double taxation agreements. However, exempt foreign source income is included in total income for purposes of determining the tax rate on the taxable income.

Where income is exempt under a double taxation agreement, losses attributable to the foreign source income may not be used to offset German tax liability. Otherwise, losses from a permanent establishment in a foreign country may be used as an offset against German income. The loss must be a net loss from all permanent establishments in the particular country. If a loss such as this exists it is regarded in German tax law as a "special expense," which is deductible from the total taxable income of the German taxpayer. This deduction must be returned to profit in any subsequent year in which the overall income from the particular foreign country is shown to extinguish even partially the loss which was previously incurred there, unless the taxpayer can show that the foreign country involved only allows claims for losses in the year of loss.

4. International Intercompany Pricing

The statutory rule on inter-company pricing is patterned on Section 482 of the U.S. Internal Revenue Code, except that it applies only to international transactions. The law allows German tax authorities to reallocate profit on transactions between related parties, even if there has not been an overall reduction on the tax burden of the group when both German and foreign taxes are taken into account.

An arm's-length standard is required for transactions between related persons.

The intercompany pricing rules apply to all related persons. Under the law, the definition of related persons is broad. All business and personal relationships between resident taxpayers and their foreign partners come within the scope of the law and are subject to investigation regarding whether the relationship has really been at arm's-length. Double taxation treaties also provide some measures for the reallocation of profits; however, their reach is less broad than the Foreign Tax Law provisions. In an appropriate case, the tax treaty provisions on reallocation take precedence over the Foreign Tax Law provisions. As to matters not within the scope of the treaty provisions, the Foreign Tax Law is operative.

In examining transactions, German tax authorities have authorized the use of the comparable uncontrolled price method, the resale price method, and the cost plus method. Detailed regulations on this subject have been published in draft form but not yet promulgated.

The need to develop the correct income mix, as discussed above, has influenced intercompany pricing policy. For firms exporting to a foreign subsidiary, there is an incentive to show adequate profit to the German parent to cover dividend distribution needs.*/

5. Controlled Foreign Corporations

The Foreign Tax Law (Aussensteuergesetz) of September 8, 1972, is the German equivalent of the U.S. subpart F provisions. This law supplements existing provisions in German tax law concerning sham transactions, abuse of law and the like, which were not believed to be adequate for dealing with international tax avoidance.

Provisions in the Foreign Tax Law of 1972 deal with the attribution to resident shareholders of base company income derived by controlled foreign corporations, called intermediate companies. Essentially, where the requirements of the Foreign Tax Law are met income of a controlled foreign corporation is attributed directly to the German taxpayer.

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*/ H. AULT & A. RADLER, supra note */ p. 23, at 37.

The attribution rules apply to all resident taxpayers. If the resident alone or together with other residents owns more than 50% of the issued share capital of a foreign corporation, or more than 50% of the voting rights, the attribution rules apply. Special provisions exist to prevent avoidance of the attribution through emigration by German residents to low-tax countries. There is no requirement that each resident shareholder hold a certain minimum share of the company; the 50% test is the only relevant test, and it must be satisfied each year.

This does not mean that all income of a controlled foreign corporation will be taxed in the hands of the German shareholders. Attribution applies only if the income of the foreign company represents income of an intermediate company. Income of an intermediate company is defined as all income which enjoys low taxation abroad and does not result from an activity classified in the law as active. Therefore, there are two tests which must be met before the attribution will apply; an income test and a country test.

(a) Income test

Active income is broadly defined. Agricultural and forestry income are always active, as is income from manufacturing. Income from trading is normally active; but if the trading is between the foreign company and a related person, it is considered active only if the foreign company maintains an establishment equipped for the transactions and if the foreign company is active in business life without the assistance of the controlling German shareholders or related persons. Similar conditions must be satisfied if income from services is to be classified as active income. Income from rental and leasing activities is generally considered passive, as is income from financial activities.

Dividends are normally not considered active. However, under the law dividends can be changed from passive to active income if certain requirements are met. If the controlled foreign corporation receives distributions which represent active income from a third corporation, then dividends by the controlled foreign corporation with respect to such distributions are considered active, provided that the controlled foreign corporation owns at least 25% of the distributing company's stock since the beginning of the distributing company's taxable year. In addition, the third corporation must be located in the same country as the controlled foreign corporation, or, alternatively, the controlled foreign corporation must hold the investment in the distributing corporation in connection with its own active business operations.

Where the controlled foreign corporation is in a low-tax country but has both active and passive income, this income may be viewed separately. However, if the taxpayer is able to prove that the passive income is complementary to the active operations, then this passive income is to be regarded as active income. An example of this rule would be the temporary investment of funds until the distribution of dividends.

(b) Low-Tax Country Test

In practice, a low-tax country is one which levies a tax at a rate of less than 30%. This rate is computed taking into account all taxes on income, capital gains, or net worth levied by the national government or local governments. Apparently, statutory rates rather than effective rates are treated as determinative.

The German Federal Ministry of Finance publishes lists of countries in which the rates are less than 30%, including countries granting special tax allowances.

Exemptions from the Foreign Tax Law rules are applicable to German resident corporate shareholders--

(i) on dividends from corporations resident in countries whose tax treaties with Germany provide for exemption of intercompany dividends (most German tax treaties contain an article to this effect); or

(ii) with respect to the attribution rules, where dividends which would be exempt under the corporation income tax rules are distributed by developing country corporations provided that the dividends are received directly by the resident German shareholder of the controlled foreign corporation.

6. Because the German resident shareholders must own more than 50% of the foreign corporation for it to be considered a controlled foreign corporation, a 50-50 relationship between a resident of Germany and a foreigner would not be subject to the attribution rules.

C. Tax Treaties

Germany has entered into an extensive network of bilateral tax agreements covering over 45 countries.

JAPAN

I. Domestic Taxation

Japanese companies are subject to tax under the Japanese National Corporation Tax (Corporation Tax) at two different corporate rates, depending upon whether the income subject to tax is retained or distributed. The rates are 42% on undistributed profits and 32% on distributed profits. Lower rates apply to the first 8 million yen (approximately $32,000) of taxable income of Japanese companies with capital of 100 million yen ($400,000) or less. Japanese corporations are subject to tax on their worldwide income with credit given for foreign taxes paid on an overall limitation basis similar to the U.S. system. Under internal tax law, foreign corporations having no permanent establishment or branch in Japan are taxed only on their Japanese source income from the transfer or lease of real property, the transfer of shares in a Japanese corporation (in certain cases), investment income (dividends, interest and royalties), the provision of personal services, and under certain other circumstances. Foreign corporations that do not have a fixed place of business in Japan are in most cases subject to a withholding tax at the rate of 20% on the gross amount.

In addition to the Corporation Tax, corporations with a head office, branch office, factory or other fixed place of business in Japan are subject to a Prefectural Inhabitant Tax and a Municipal Inhabitant Tax, the combined rates of which are between approximately 7.2% and 8.6% of taxable income. Such corporations are also subject to a prefectural Enterprise Tax levied at progressive rates of 6 to 12% of taxable income (6.6 - 13.2% for Tokyo and certain prefectures). This tax is deductible in computing taxable income for purposes of the Corporation Tax.

Under the Japanese "modified integration system," individual Japanese shareholders can claim a credit for 10% (in some cases 5%) of dividends received from a Japanese corporation. There is no gross up for the credit amount. Dividends received by Japanese corporate shareholders from other Japanese corporations are not recognized as income for tax purposes, except that 25% of the excess of dividends received over paid-out dividends is treated as taxable income. Dividends received by Japanese corporate shareholders from foreign corporations are fully taxable.

II. Foreign Taxation

A. Export Incentives

1. Enterprise Tax Remission

While all Japanese corporations are subject to the 12% Enterprise Tax, the portion of their profits attributable to a permanent establishment abroad is excluded from the tax base for purposes of computing the Enterprise Tax.

2. Reserves

A Japanese corporation with paid-in capital of 500 million yen ($2,000,000) or less which engages in overseas transactions may set up a "medium and small enterprise overseas market development reserve." This reserve, which is deductible from the base on which the corporate tax is levied and must be amortized over 5 years by taking 1/5 of the reserve into taxable income each year for tax purposes, has as its basic function a deferral of tax on export activities. The amount of the reserve is computed as follows:

(a) Export of Merchandise Bought from Others

  (i) A corporation with paid-in capital of 100 million yen ($400,000) or less -- 1.36% of annual export sales of merchandise.

  (ii) A corporation with paid-in capital of over 100 million yen ($400,000) and up to and including 500 million yen ($2,000,000) -- 0.66%.

(b) Other Exports (Exports of Merchandise Manufactured, Processed, etc.)

  (i) A corporation with paid-in capital of 100 million yen ($400,000) or less -- 1.84%.

  (ii) A corporation with a paid-in capital of over 100 million yen ($400,000) up to and including 500 million yen ($2,000,000) -- 0.90%.

If, for example, a corporation with paid-in capital of 100 million yen ($400,000) has yen equivalent $1 million in gross sales in year 1 and in each successive taxable year, then in year 1, $18,400 would be the amount of the deductible reserve. One-fifth of the reserve must be restored to income in each of the subsequent five years. However, given steady exports of $1 million per year, after year 5 there would be a continuous (and permanent) deferral of tax on about $55,200 of profit.

B. Taxation of Foreign Income

1. In 1978 Japan adopted certain anti-tax haven measures which operate in a manner similar to the U.S. subpart F provisions. These provisions apply to subsidiaries located in certain listed tax haven countries (about 30 countries in all).

2. Japanese exporters utilize export sales subsidiaries located in certain preferred locales. Among the preferred locales are Hong Kong, Singapore, and the U.K.

a. Hong Kong and Other "Tax Havens"

Although countries such as Hong Kong are listed as tax haven countries under the anti-tax haven measures, these measures are not applicable to a subsidiary with a head office -- which is the office so denominated in the company's Articles of Incorporation -- in a tax haven country provided:

(i) the subsidiary maintains an office, shop, factory or other fixed facility in the country of its head office;

(ii) the subsidiary actually conducts the administration, control and arrangement of its business in the country of its head office;

(iii) in the case of a wholesale business, both the sales and purchases of the subsidiary with related parties are less than 50% of the total sales and purchases respectively; and

(iv) the dividends of the specified foreign subsidiary received from other foreign subsidiaries are not more than 5% of the total revenues of the specified foreign subsidiary.

The test for whether a subsidiary in a tax haven country actually conducts the administration, control, and arrangement of its business in the tax haven, is one of substance. However, there would appear to be no problem if space were shared by two or more businesses. If two businesses shared the same employees, however, it is questionable whether the substance test would be met. Japanese tax authorities have no enforcement powers outside of Japan and foreign audits are generally based on voluntary cooperation.

b. Singapore

Singapore is not listed as a tax haven country. Singapore has an income tax treaty with Japan and does not have foreign exchange control regulations. The corporate income tax rate of Singapore is presently 40%. A taxpayer would not be considered doing business in a tax haven country with respect to a Singapore sales subsidiary even if, as is not uncommon, the Singapore sales subsidiary were not actually paying tax in Singapore by reason of a tax holiday.

Singapore itself does not tax profits of a Singapore company from overseas business if the profits are physically kept outside of Singapore. This may be accomplished by maintaining a bank account outside of Singapore.

c. United Kingdom

A non-resident U.K. company presently is not taxable in the U.K. on its income outside the U.K. A U.K. subsidiary with its center of management outside the U.K. has been used by certain Japanese companies.

3. Arm's-Length Pricing Rules

Japanese tax law contains an arm's-length pricing requirement. The arm's-length rule is generally interpreted to mean that profits must be allocated in light of each party's contribution to the realization of those profits, among other pertinent factors (such as comparable uncontrolled prices). There are no regulations interpreting the rule, and it is apparently difficult to apply in the case of a parent corporation that is publicly-held unless the pricing is clearly unreasonable.

The Japanese tax authorities infrequently challenge pricing, and there has never been a Japanese court case on the issue. Showing severe competition in a product would generally be sufficient to justify lowering prices to a purchasing subsidiary. (For reasons peculiar to Japanese society, it would be highly unusual for a pricing question not to be settled out of court.)

4. Foreign Tax Credit

By application to the Japanese tax authorities, for purposes of computing the Japanese overall foreign tax credit limitation, losses incurred by a foreign branch in one country will not reduce foreign source income in other countries.

5. Commodity Tax

The commodity tax (which corresponds to a manufacturer's excise tax under U.S. concepts) is levied at a rate of from 5% to 30% depending upon the product. Examples are: large and medium size passenger automobiles -- 30%; small size passenger automobiles -- 15%; dishwashers, ovens, mixers, etc. -- 15%.

Exports are exempt from the commodity tax. Imports are subject to the commodity tax.

C. Tax Treaties

Japan has tax treaties with 34 foreign countries including the U.S., U.K., France, Germany, Sweden, and, as previously noted, Singapore.

NETHERLANDS

I. Domestic Taxation

Dutch companies and residents are subject to tax on their worldwide income. The general rate on corporate taxable income is 48% if net profits, including foreign branch profits, are greater than 50,000 guilders. Under 50,000 guilders, the rate is 45% on the first 40,000 guilders and 60% on the next 10,000 guilders (1 guilder is approximately 0.37 dollars).

Formation expenses of a domestic corporation may be fully deducted from taxable income in the first year of operation or, alternatively, capitalized and amortized over three to five years. The primary formation expense, in addition to the normal costs, is a one-time only capital tax. This capital tax is levied at a rate of 1% of the capital contributed to the new corporation. If a Dutch company purchases the goodwill of another company, that goodwill may be capitalized and amortized over a five year period.

There are no official guidelines as to the method of depreciation. Any businesslike method is acceptable. In practice, straight line is normal, with alternative methods allowed only if it can be demonstrated that the alternative method better reflects the decrease of the asset's value.

There are special tax incentives for investment. The Act on Investment Account (WIR) of 29 June 1978 replaced prior accelerated depreciation, etc. with respect to certain areas in the Netherlands where as a matter of policy the government wishes to encourage investments. There are two types of incentives -- investment premiums and supplemental premiums. Investment premiums act as offsets against tax liabilities, and, if they exceed tax liability, become a negative income tax paid to the corporation. More than 2,000 guilders must be invested in qualified investments during the year for the premium to be allowed. The premium schedule is: new buildings -- 14%; existing buildings -- 8%; all other business assets -- 12%. These premium rates may be increased under certain circumstances. First, if investments are less than 976,904 guilders but exceed 40,706 guilders, the foregoing percentages are increased by from .25 to 6 percentage points, the higher increases being applied to the lower investment totals. Second, for designated municipalities in need of economic assistance, the above rates are increased. For investments in buildings, 20 percentage points are added; for other fixed installations, 10 percentage points are added; and for expansion of existing fixed installations, 10 percentage points are added.

In addition, for major investments totalling more than 39.8 million guilders, up to 4 extra percentage points are given. At least 10.6 million guilders must be invested in buildings or fixed installations. Also, a fixed subsidy of 33,100 guilders is given for each new employment position created by the major investment.

Neither investment premiums nor supplemental premiums reduce the basis of the assets for purposes of normal depreciation. All premiums applicable to one investment must not collectively exceed 50 percent of the investment.

Dutch tax law allows companies to set up certain tax-free reserves. These are:

1. maintenance reserves, which are formed for the purpose of spreading evenly over a number of years certain major expenditures which occur at regular (though not, apparently, yearly) intervals;

2. reserves designed to cover risks in the normal course of business that would normally be insured by a substantial number of taxpayers; and

3. where a company receives funds with respect to a capital asset which is greater than its book value, the excess may be placed in a reserve, provided that the taxpayer intends to replace the capital asset. The replacement asset must be of a similar nature and have the same economic function in the company's business. When the asset is replaced, the cost price (basis) is reduced by the amount of reserve for depreciation purposes. If the reserve is dissolved without the capital asset being replaced, the balance of the reserve must be included in taxable income at that time. Otherwise, the reserve must be returned to income after three years.

A value added tax of 18% is imposed on goods sold in the Netherlands.

II. Foreign Taxation

A. Export Incentives

1. Value Added Tax

Dutch companies can get 100% of the VAT refunded on goods and services which are exported.

B. Taxation of Foreign Income

1. Foreign Branch Income

Income received with respect to a foreign branch is includable in the corporation's taxable income. Where the foreign branch constitutes a "permanent establishment" or a "permanent agent" in the foreign country, however, the profits attributable to that branch are in fact exempt from taxation by the Netherlands. The attribution of part or all of the corporation's aggregate profits to the branch is based on the assumption that such branch is to be treated as a seperate enterprise while applying the arm's-length pricing principle. The level of profits which can be attributed to the branch will therefore primarily depend on the "substance" of the branch as compared to the substance of the corporation's total operations. Neither "permanent establishment" nor "permanent agent" is defined under Dutch law; however, it is essential that the foreign operation show a certain degree of permanence. The performance of work for a period longer than 12 months is explicitly mentioned as qualifying. Generally, an office with employees will qualify, as will a dependent agent with permanent authority to represent the Dutch company.

Foreign branch net profits are generally exempted from Dutch tax pursuant either to a treaty or unilateral measures for relief from double taxation. Under unilateral relief, the only requirement for exemption (other than the permanent establishment requirement) is that the foreign branch income be subject to foreign tax. However, it is not necessary that the tax in fact be levied or paid. If a tax holiday results in no tax, the foreign branch income could still be exempt from Dutch tax provided, however, that the tax holiday is clearly intended as a temporary measure or incentive. Should the tax holiday appear to be in fact a more permanent suspension of the income tax laws, no relief may be available and the foreign branch profits will be subject to Netherlands income taxes. The actual rate of tax imposed is irrelevant provided the tax qualifies as a true income tax. A high local turnover tax rather than an income tax could disqualify foreign branch income for the exemption/credit relief. Tax treaties may remove the requirement that the branch be subject to an income tax. This is not always the case, as the U.S. - Netherlands treaty demonstrates. Tax havens can only be attractive for foreign branch operations if the tax haven levies some kind of income tax on the branch income and if the branch has sufficient substance. Without substance no substantial income could be attributable to the branch.

Net losses from foreign branch income may be deducted from domestic taxable income, thus reducing the tax liability of the Dutch company. However, this net loss must be recaptured by reducing the exemption for foreign branch profits in one or more of the subsequent eight years.

If domestic operations produce a net loss while foreign operations produce a net profit for the corporation, the worldwide profit -- net foreign and domestic profit -- will be less than foreign profit. In such a situation the excess foreign profit (more than necessary to reduce, through exemption, the corporate taxable income to zero) may be carried forward for eight years and acts so as to increase the exemption with respect to foreign profits in those years.

Preferred locations of foreign sales branches are Cyprus for Middle East sales, the Netherlands Antilles for the Americas, and Switzerland for Europe.

2. Foreign Subsidiary Income

There is no direct taxation on the income of a foreign subsidiary of a Dutch company. Both dividends received and capital gains arising from a foreign corporation in which a Dutch company has an interest are generally exempt from Dutch taxation. To qualify for this exemption, the Dutch company's interest in the foreign corporation must meet several tests:

(a) the Dutch company must have at least a 5% equity interest in the foreign corporation;

(b) this interest must be held continuously from the beginning of the taxable year;

(c) the subsidiary company must be subject to foreign income tax (but the rate is irrelevant and withholding at source is not required);and

(d) the shareholding must not constitute passive portfolio investment.

Some controversy has surrounded the last requirement. The Dutch Supreme Court ruled in 1973 that a Dutch holding company, owning 100% of several foreign subsidiaries, was not eligible for the dividends exemption because the holding company did not, by definition, have any business activities. This led to considerable discussion which resulted in a Dutch Tax Administration ruling that "active coordination" of foreign subsidiaries was enough to remove such holding companies from the "passive portfolio investment" category. This ruling permits the taxing authorities to grant the exemption where the subsidiaries are active operating companies and where the shares of the Dutch holding company are in turn owned by an active company of substance since, in this case, there is a direct management line between the parent of the Dutch company and its subsidiaries. Therefore, by its nature the Dutch holding company cannot own subsidiaries as portfolio investments, but rather acts as a conduit to an overseas parent and is considered as "coordinating" foreign subsidiary income.

Tax treaties usually provide the Dutch parent with a tax credit for withholding taxes on interest, dividends, or royalties paid to a foreign state. Where there is no treaty with the foreign state, foreign taxes paid (where other exemptions do not apply) are deductible expenses to the Dutch parent. Additionally, tax credits are allowed on withholding taxes paid with respect to interest and royalties by a resident of certain lesser developed countries (LDCs). Currently, approximately 80 LDCs qualify for this credit. The tax must actually be paid in this case.

3. Intercompany Pricing Rules

Under Netherlands tax law, the authorities can adjust the prices of intercompany transactions if it is established that these are not at arm's-length. Arm's-length pricing implies that the manufacturer receives its cost plus profit mark-up for its manufacturing activities. On the other hand, the profit of the sales subsidiary should also reflect an arm's-length result taking due notice of its activities and function. As a practical matter, tax authorities will not find arm's-length pricing to exist where the parent company shows a loss on the transaction and the foreign sales subsidiary shows a profit on subsequent resale unless the arm's-length character of this transaction can be demonstrated beyond a doubt by the taxpayer. Such a demonstration is usually impossible.

There are no fixed rules in the Netherlands for profit allocation. The existence of an arm's-length transaction is determined on a case-by-case basis depending on the facts and circumstances; there are no safe-haven rules. Companies can negotiate this point with the Dutch taxing authorities prior to the transaction, and reach an agreement which is good for a considerable period of time -- over several years. Rulings such as this are binding on the Dutch tax authorities.

A transfer of profits already certain or a profit potential by a Dutch company to a foreign sales subsidiary could be construed by the tax authorities as a transfer of goodwill. Once this profit is realized, its value would be taxable to the transferor at normal rates (capital gains are not taxed at special rates).

The use of foreign sales subsidiaries is discouraged to some degree by the fact that the Netherlands Credit Company, a Dutch government institution, will not insure credits extended to foreign related parties with respect to exports.

C. Tax Treaties

The Netherlands has entered into an extensive network of bilateral tax agreements with over 35 countries.

SWEDEN

I. Domestic Taxation

Swedish corporations are subject to tax on income from whatever source. The decisive factor for determining residence is the nationality of the corporation, not its place of management. Thus, corporations formed abroad which are managed from Sweden are generally not subject to Swedish taxation.

Swedish corporations are liable for two taxes on income, the National Tax and a municipal or local tax. The rules for computing net income are essentially the same for both. The National Tax is levied at a flat rate of 40% on net income. The local tax is also applied at a flat rate, but this rate is set by local authorities. On average the local tax rate is about 29%, but there is a variation among localities of about 7 percentage points.

In computing taxable income, Swedish corporations are allowed deductions for current expenses. Deductions are allowed for municipal taxes imposed either directly or indirectly on the Swedish corporation. Foreign income taxes imposed may be either credited against Swedish taxes or taken as a deduction; foreign excise taxes are deductible. In addition, there are special provisions governing depreciation, capital gains, and special reserves. Net losses may be carried forward for a period of 10 years.

When an asset is sold, unused depreciation may be written off to the extent it exceeds the proceeds from the sale, while proceeds in excess of the remaining depreciation become taxable profits.

There are two methods of depreciation available -- the book method and a variation on the book method called the remaining balance method. The book method generally allows for depreciation of assets other than buildings at the rate of 30% annually.

There is no separate tax on capital gains. Capital gains when taxable are included in ordinary income. Assets are divided into three main categories: real property, shares and other similar securities, and movable property excluding shares. Inflationary appreciation in the value of real property is not subject to tax. Capital gains from the sale of movable property other than shares receive very favorable tax treatment with no tax liability at all if the property is held for more than 5 years.

Capital gains from the sale of shares are taxable regardless of how long the shares have been held. If the shares sold have been held for a period of less than two years, 100% of the gain is taxable as ordinary income. If the shares have been held for two years or more, only 40% of the gain is treated as ordinary taxable income. Capital losses on the sales of shares may be fully deducted if the shares have been held for less than two years, while 40% of the loss may be deducted for shares held two years or longer. Capital losses are only deductible against capital gains; net capital losses may not be set against net operating income for the purpose of computing taxable income.

There are three principal types of tax-free reserves permissible under Swedish tax law. The first is a reserve with respect to inventories. The second is a profit equalization reserve. The third is a general investment reserve.

The tax-free reserve with respect to inventories is essentially a form of depreciation on the value of inventory acquired each year. The profit equalization reserve allows companies engaged in business or agriculture to allocate up to 20% of their total annual payroll to a tax-free reserve. This reserve is returned to income in the following taxable year; however, because this reserve can be set aside each year, it in effect acts as a permanent deferral.

Swedish companies may allocate up to 50% of their annual profit, before taxes, to a general investment reserve, which is deductible for national and local income tax purposes. Half of this reserve allocation, however, must be paid into a special investment account at the Swedish National Bank. If the government requires, or if the company requests and the government approves, the investment reserve may be used for certain domestic purposes or for development of an export market. After five years, the company is entitled to reclaim 30% of the deposit made in the Swedish National Bank without the need to seek special permission. This amount may be used for most, but not all, of the permitted purposes.

A value added tax is levied at a nominal rate of 17.7% on approximately 70% of the goods and services consumed within the country. This nominal rate corresponds to a rate of 21.51% on the price excluding the value added tax itself from the base. There is a reduction of the value added tax on some goods and services.

There is no general provision in Swedish tax law which relieves profits made by a corporation from taxation at both the corporate and the shareholder levels. In the case of dividends received by a Swedish parent corporation from another Swedish company in which the parent owns at least 25% of the voting power, dividends are exempt from taxation to the Swedish parent. Swedish companies which are classified as holding companies or investment companies are not eligible for this exemption. In the case of holding companies, tax liability exists on dividends received to the extent that the amount of such dividends does not correspond to dividends paid to the holding company's own shareholders in the same income year. Investment companies are allowed exemption from tax on dividends received if their own dividends paid out for the same income year correspond to 80% of the dividends received.

As of 1983, a company which is not quoted on the stock exchange will, under certain conditions, be entitled to a deduction in respect of distributions made during a fiscal year. This deduction will be limited to companies which are carrying on business, agriculture or forestry. A holding company will not be entitled to this deduction. The deductible amount will be limited to 70 % of the distribution. However, the deductible amount may not exceed 15 % of the share capital or SKr 700,000 (approximately $115,000) per year. A deduction will not be allowed if the recipient is exempt from tax on the distribution received. This means that the deduction will not be given to the extent that the distributing company is owned by a company which in its turn is not taxable in respect of the dividends received. This feature obtains if the recipient holds 25 % or more of the shares of the distributing affiliate.

A second special deduction is allowed in certain cases to companies with respect to dividends distributed. A distributing company may deduct from its profits the amount of the dividend distributed to its shareholders up to a total of 10% of the paid-in capital of the corporation in a single year. This deduction may be taken annually over a period of twenty years; however, it is limited to a total of 100% of the qualifying paid-up capital. Swedish holding companies which own shares representing in excess of 50% of the voting stock of the distributing company do not qualify for this special deduction. The deduction is not available for a Swedish parent company owning in excess of 25% of the voting stock of the distributing company; nor is it available where Sweden must reduce the withholding tax on outgoing dividends to zero under a tax treaty with the country of the recipient. This deduction reduces the amount of the deduction which may be taken by a company under the provisions outlined in the previous paragraph.

Nonresidents are taxed on Swedish source income derived from business, royalties or real estate situated in Sweden and any gains from the disposition of business assets or real estate in Sweden. The taxable income of a Swedish branch of a foreign corporation is computed as if the branch were a resident corporate entity. Foreign corporations that establish a Swedish office that functions as a management headquarters are not taxed if the office does not generate a profit and does not engage in selling activities. Nonresident companies are subject to the National Capital Tax on net assets located in Sweden at the end of each year. This tax is almost always waived under Swedish tax treaties. Interest paid to individuals or corporations abroad is not taxable in Sweden. Dividends paid to nonresidents are no longer treated as taxable income. A withholding tax of 30% is levied instead. Withholding rates for nonresidents living in countries with which Sweden has a double taxation agreement are generally significantly lower than 30%.

II. Foreign Taxation

A. Export Incentives

1. The Investment Reserve

As indicated above, a Swedish company may create a tax-free investment reserve which may subsequently be used for certain government approved purposes. One of these purposes is for the development of export markets.

2. Value Added Tax

There is no value added tax imposed on goods destined for export. In addition, export transactions are not subject to excise taxes.

3. Export Credit Support

The Swedish government may grant a special allowance against taxable income under the following circumstances.

(i) The export is of significant importance to the Swedish economy and the current employment situation, and there is reason to assume that the applicant's foreign competitors have access to export credit support in their home countries.

(ii) The export consists of capital goods or consulting services to be used in the country in which the buyer is domiciled or, in the case of a subcontract, to be used in the country to which the goods are sold by the main contractor.

(iii) More than half of the agreed-upon purchase price and not less than SKr 300,000 (approximately $49,000) is covered by an export credit.

(iv) The credit runs for a period of at least 2 years.

(v) At least half the amount needed to finance the credit is borrowed in a bank or credit institution. The maximum allowance is 4% of the outstanding export credit claims at the beginning of the financial year. To obtain this special allowance, a Swedish company must apply to the Swedish tax authorities before the end of the taxable year in which the export credit agreement is concluded. The allowance may not generate a loss on the total taxable income of the business. If because of this provision the company cannot obtain the full benefit of the special deduction allowance, the company may apply for a grant of up to a maximum of 50% of the calculated allowance. The grant is not taxable income.

B. Taxation of Foreign Income

1. A Swedish company is taxable on its worldwide income regardless of source. Both the national and local taxes have to be paid on worldwide income.

2. There is no Swedish equivalent of U.S. subpart F provisions. However, there is a provision which allows Swedish tax authorities to "look through" a corporation's foreign site of incorporation. If the corporation is formed abroad with the obvious purpose of evading Swedish taxes, but is owned by Swedish citizens, the tax authorities may tax it as a Swedish economical association although it is not in fact a Swedish corporation. Application of this provision is infrequent. Profits of foreign subsidiaries are taxed only when distributed to the parent company.

3. Unless a tax treaty provides otherwise, dividends from foreign subsidiaries are not eligible for the dividends received exemption. However, a Swedish company may be granted a dividends received exemption for dividends from a foreign subsidiary by special decision of the National Tax Board.

4. Relief from double taxation on foreign source income of Swedish companies is normally provided by double taxation agreements. There are, however, certain unilateral provisions in Swedish tax law which at least mitigate double taxation where there is no bilateral agreement in force. Sweden grants partial relief from double taxation of foreign source income by allowing foreign taxes to be deducted as an expense in computing taxable income. To the extent this deduction does not eliminate double taxation, a foreign tax credit is also allowed. The foreign tax credit is creditable only against the national income tax; it cannot exceed

the Swedish tax attributable to the foreign income. There is no such credit available with respect to the local tax. These unilateral relief provisions are currently being considered for amendment.

Generally, a foreign branch is regarded as a dependent part of the Swedish company. Losses of such a branch may be deducted from domestic earnings even where Sweden has entered into a tax treaty under which Sweden may not tax the income of the foreign branch.

5. Foreign Tax Credit

If a taxpayer chooses to deduct, rather than credit, foreign taxes paid, the deduction is used in the calculation of both the national and the municipal tax bases. The credit, however, may only be used against the National Tax. Often a deduction is taken for estimated foreign taxes but, when settled, the Swedish company will refile and claim a credit, instead, if that is more beneficial.

6. Intercompany Pricing Rules

Where a Swedish corporation and a foreign corporation are related or members of the same group, Swedish tax law requires arm's-length pricing. There are no detailed regulations in Sweden regarding the application of this rule. Where Swedish tax authorities find that the dealings between the Swedish company and the foreign company have not been based on arm's-length principles, they may reallocate the income.

Interest paid by a Swedish corporation to a nonresident parent corporation is generally deductible to the Swedish subsidiary. However, a deduction may be denied for excessive or unreasonable payments which are then treated as a concealed dividend paid by the Swedish subsidiary to the foreign parent corporation. Interest paid to a foreign resident by a Swedish resident is not subject to withholding in Sweden; this is in line with the general exemption from Swedish tax of interest received.

C. Tax Treaties

Double taxation agreements usually provide for a tax-free distribution of dividends from a foreign subsidiary to a Swedish parent under the same conditions as those imposed for qualification for the dividends received exemption on dividends received from a Swedish subsidiary by a Swedish parent.

Double taxation agreements avoid double taxation by one of two methods -- exemption of income or ordinary tax credit. Under the exemption approach, the double taxation agreement allocates items of income to taxation by one of the two countries and exempts them from tax in the other. Where the ordinary tax credit method is used, both Sweden and the other country may tax the income, but Sweden must reduce its tax on Swedish residents by an amount corresponding to its own tax or the tax of the country of source, whichever is the lower. The exemption method was the principal method used in double taxation agreements entered into before 1965. Since then, the ordinary tax credit method has dominated in Sweden's tax treaties. As noted above, the losses but not the gains of a branch of a Swedish company located in a treaty country with a tax exemption type treaty may be taken by the Swedish company.

UNITED KINGDOM

I. Domestic Taxation

A corporation with its place of management in the U.K is subject to U.K. corporate tax on its worldwide income. Place of management is determined on the basis of all the relevant facts and circumstances. Important factors include where the members of the Board of Directors hold their meetings and the place of residence of the directors.

The U.K. corporate tax rate is 40-52%. Nonresident corporations are liable for U.K. tax only on income from a trade within the U.K. Also, nonresident corporations are subject to tax on certain U.K. source income under a withholding system similar to the U.S. system. U.K. resident corporations may credit foreign income tax paid against U.K. corporate tax on foreign source income under a system similar to the U.S. system but with a "per country" rather than an "overall" limitation.

Individual U.K. shareholders of a U.K. company must gross up dividends paid to them by a fraction (changed annually, but approximately 3/7ths) of the distributed amount. They may then take a credit against their U.K. taxes in the amount of the gross-up. This partially alleviates the full taxation of corporate profits at both the corporate and shareholder levels.

The U.K. tax system provides for an advance payment of the corporate ("mainstream") tax through the mechanism of Advance Corporation Tax ("ACT"). A U.K. corporation making a distribution to a U.K. shareholder must make quarterly payments of ACT, in an amount equal to the fraction described above, of distributions made during the quarter, but it may offset this amount against its mainstream corporate tax liability at year-end. Although no refund of ACT is permitted if mainstream liability at year-end is less than ACT paid during the year, the excess ACT may be carried forward indefinitely or transferred to an affiliated corporation during the same income tax year.

Especially noteworthy features of U.K. corporate tax include its system of depreciation and stock relief provision. A U.K. corporation may elect to take 100% depreciation in the first year of acquisition for machinery and plant (79% for the construction of industrial buildings). This election is restricted to U.K. resident corporations, but applies to their worldwide assets. Under the U.K. stock relief provision, payment is forgiven on the portion of the corporate tax which is considered attributable to inflationary price increases in inventory.

A liberal form of consolidation is allowed U.K. companies through provisions known as "group relief."

II. Foreign Taxation

A. Export Incentives

1. A border tax adjustment is provided in the form of a refund of the value added tax (generally 15%) on all exported items.

2. A deduction is permitted for business entertainment expenses of customers resident overseas. No similar deduction is provided for expenses of entertaining domestic customers.

3. In 1977, legislation was enacted permitting anyone who works overseas for at least 30 days in any tax year to claim a tax deduction of 25% of their overseas earnings. Section 31, Finance Act 1970. The days spent working abroad do not have to be consecutive, as long as they total more than 30 days. Normally the salary to which the 25% deduction applies is calculated on a time-apportionment basis (days overseas divided by 365). Where an executive has a separate contract for an overseas employer which is not an affiliate of the UK employer, the 25% deduction applies to the actual salary earned overseas. If 365 days or more spanning two tax years are spent working abroad then none of the employee's overseas earnings are taxable in the U.K.

B. Taxation of Foreign Income

1. The U.K. does not have an equivalent of the U.S. subpart F provisions. The issue of whether to impose a variation of subpart F was recently raised in a "consultative" document issued by the U.K. Treasury in January 1981. In November 1981, however, these proposals were withdrawn from parliamentary consideration. There is thus nothing in U.K. law to prevent the accumulation of foreign source earnings of subsidiaries of U.K. corporations in low tax jurisdictions (other than with respect to personal holding companies, whose accumulation of profits is limited by section 478 of Taxes Act 1970).

2. Section 482 of the Taxes Act 1970

The prohibition against creating foreign sales subsidiaries, which formerly existed under the U.K. foreign exchange control laws, was ended in 1979. The only other measure in U.K. law which might bar establishing a foreign sales subsidiary in a tax haven jurisdiction is section 482 of Taxes Act 1970.

This section prohibits "migration" of an existing trade of a U.K. corporation. It is apparently a small hurdle for any international concern with access to expert advice. Appropriately drafted applications for an exception to section 482 are usually accepted, especially since the abolition of exchange controls. An exception is necessary only in the case of an existing U.K. corporation that wishes to move a part of its trade outside the U.K. No approval is needed to create a new company overseas to conduct sales if this is a new activity. Accordingly, a U.K. manufacturer which has previously sold to overseas distributors but who wishes to incorporate its own overseas distribution subsidiary would be exempt from section 482 because it is not transferring the trade of distribution out of the U.K. An overseas sales subsidiary should have some corporate substance to avoid the argument that its seat of management is in the U.K.

Applications for sales subsidiaries in a Crown Colony, such as Hong Kong, appear to be routinely approved.

While criminal penalties exist for enforcing section 482 -- against both the company and its professional advisors -- no prosecutions have ever been brought under this section.

3. Transfer Pricing

There is no special provision of law for dealing with international sales at an understated or overstated value. Section 485 of Taxes Act 1970 provides a rule, similar to U.S. section 482, requiring arm's-length dealing between controlled entities. To date, there have been no decided cases under section 485.

Factors which a U.K. company may show in order to justify low transfer prices include commercial factors such as market penetration difficulties and competition. Experience has shown that a U.K. company may also show that the activities of a foreign sales subsidiary will increase U.K. exports. Such assertions are known to have considerable influence on the attitudes of the authorities towards low prices for export to selected companies.

A specialist team to insure compliance with an arm's-length standard has recently been created by the Inland Revenue and charged with reviewing all transactions between U.K. companies and overseas companies. However, the size of the unit is only fifty individuals.

4. Foreign Tax Credit

While the U.K. operates on a per country limitation for foreign tax credit purposes, an overall limitation may effectively be obtained by the interposition of a holding company between the overseas subsidiaries and the U.K. parent. A Dutch holding company is commonly used for this purpose. Excess foreign tax credits may not be carried over.

An indirect foreign tax credit may be claimed provided the U.K. parent owns at least 10 percent of the voting power of the subsidiary paying dividends. Unlike the U.S., the ownership requirement is examined at each level. Thus, if a U.K. resident company owns 10 percent of a foreign company which in turn owns 10 percent of a second foreign company, the U.K. resident will receive a credit for its proportionate share of the taxes paid by both foreign companies.

A U.K. corporation may choose to deduct, rather than credit, foreign taxes paid.

5. Favored Locations

Favored locales for establishing overseas sales subsidiaries include: Bermuda, the Bahamas and the Netherlands Antilles for distribution operations to Central, North and South America; Cyprus for sales operations in the Middle East; Hong Kong, often in conjunction with overseas manufacturing subsidiaries in Singapore, for Far East sales and distribution; and the Channel Islands for European sales or international marketing generally.

C. Tax Treaty Rules

Several countries have secured the inclusion in their double-tax treaties with the U.K. of a "tax sparing" article preserving foreign tax credit benefits to the U.K. corporate investor even if the tax for which credit is sought is not paid due to a tax holiday or other tax relief measure in the other contracting state.

APPENDIX

Telex to Correspondent Counsel

To: Correspondent Counsel

Re: Export Practices

1. We represent U.S. exporters interested in surveying actual export practices followed in ________________.

2. While some information is available from treatises and other secondary sources, we must obtain current information and information which reflects actual experience. If a statutory provision calls for one result and another result is actually achieved by exporters (by government concession, for example), we must focus on the latter.

3. I will telephone you on ____________________________, unless you telex a more convenient date, to discuss this matter. If it is decided at that time that you will undertake this project, I will ask that you research the questions, call me if there are any questions arising as a result of that research, telex me the answers, and be available for additional questions.

4.1. Assume that M is a manufacturer resident and taxable in ______________. M desires to export items of manufacture from _______________ to Country Y. It wishes to utilize a foreign sales subsidiary and to allocate as much taxable income as possible to that subsidiary in order to minimize its domestic taxes. (If a particular foreign locale or locales are favored as a base for such subsidiary, assume that the subsidiary is located in such a locale. Please identify such locale(s) and identify why such locale(s) are favored. If another approach to minimizing home country taxes is preferable, please identify this approach.)

4.2.1. When computing combined parent and subsidiary export profits, what deductions, reductions, offsets, etc., are allocated against export transactions? Specifically, are interest, head office expense, general and administrative expense, research and development, plant, overhead, depreciation, or other fixed manufacturing costs, pension, generally allocated to export sales? Note that to the extent that any allocable expense is ignored in the combined export profit calculation, calculated profit is increased, and there is the possibility that some of this profit increase might be attributed to the foreign sales subsidiary.

4.2.2. On solidly profitable export business (i.e., business with pre-tax margins of greater than 4 percent of gross export receipts), what is the allowable split on profits between M and the subsidiary (for example, 50:50; 75:25)? Is any basis other than percentage split utilized (e.g., dollars per dollar gross export receipts or setting prices from the parent to the foreign sales subsidiary at some minimum markup over defined costs)?

4.2.3. On marginally profitable export business (i.e., business with pre-tax margins of 4 percent or less) or on so-called loss business (where customer prices do not cover direct costs plus full absorption of allocable expenses), how many dollars per dollar gross export receipts are allowed to accrue to the subsidiary? What procedures insulate the subsidiary from possible losses on individual export transactions?

ECONOMIC IMPACTS OF THE DOMESTIC INTERNATIONAL SALES CORPORATION (DISC) TAX PROVISIONS

A Study Prepared for

The American Business Conference
The Business Roundtable
The Emergency Committee for
American Trade
The National Association
of Manufacturers
The National Foreign Trade Council
The Special Committee for U.S. Exports
The U.S. Chamber of Commerce

April 15, 1982

Prepared by

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April 15, 1982

Mr. R. T. McNamar
Deputy Secretary
Department of the Treasury
Washington, D.C.

Dear Mr. McNamar:

The undersigned business organizations and their members believe that the DISC program provides valuable assistance to U.S. exporters and enhances the international competitiveness of the United States.

In our meeting with you earlier this year, you asked for data in support of our contention that DISC provides a cost effective export incentive. The Price Waterhouse study transmitted herewith makes it amply clear that Treasury receives significant new revenue as a result of DISC, possibly enough to make the overall cost of DISC negative. The middle range of the estimates calculated by Price Waterhouse suggest that, "For every dollar spent on DISC in terms of revenues foregone, the Treasury receives $1.24 in additional revenue collections." We have discussed these findings with Under Secretary Ture and have provided him with a copy of the Price Waterhouse report.

The study is largely confined to the revenue effect of DISC, an area of special interest to the Treasury. There are, however, additional compelling arguments in support of DISC.

The legislative history to the Revenue Act of 1971 explains that an export incentive like DISC is necessary to off-set the tax advantages inherent in the tax structures of many of our trading partners. In this connection the legislators referred both to territorial tax provisions, which limit corporate activities subject to tax to those carried out within the borders of the taxing country, and to multistage sales taxes or value added taxes. In other words, DISC is designed to remove a disincentive to exporting that is a peculiar feature of U.S. tax law.

In discussing DISC as a tax incentive, it is important to be clear that it is not a subsidy. Ambassador David MacDonald explained the outcome of the GATT action affecting DISC in a memorandum to the Private Sector of December 8, 1981. It is useful to quote briefly from that memorandum:

> "At the December 8, 1981, GATT Council meeting the GATT Panel reports on DISC and the related tax practices of France, Belgium, and the Netherlands were adopted by the GATT Council with a qualification which reflects acceptance by these countries and the EC of the principle that an exporting country need not tax economic activities involving exported goods located outside its territorial boundaries. It is our view that the U.S. global system of taxing export sales, inclusive of the DISC provisions, is consistent with this principle...."

Obviously, if there is no obligation to tax, there can be no subsidy either through the failure to tax or through tax deferral. Ambassador Brock recently delineated the practical ramifications of this principle in a letter to Chairman Gibbons of the House Ways and Means Subcommittee on Trade. "Because the U.S. method of taxing exports results in a level of taxation above the level invoked in a territorial system," Ambassador Brock wrote, "we believe that the U.S. is under no obligation to modify or repeal the DISC."

The strength of the Price Waterhouse report is solid economic analysis, analysis that should put to rest the idea that DISC is not cost effective. A discussion of the role DISC plays in the life of the more than 7,000 companies that utilize DISC provisions is, however, beyond the scope of the report. It is nevertheless very relevant to an appreciation of the importance of DISC. If you wished to have them, we would be pleased to submit to you comments from individual companies on the value of DISC to their operations. A facet of DISC illuminated by such comments is that it has helped firms to appreciate better the value to them of the export market and to plan accordingly, specifically by allocating investment and marketing resources for exports. By making the foreign market a separate profit center, DISC has made it more visible to financial managers.

Increased exports can help the United States recover from recessions like the present one. That point is well documented in the Price Waterhouse study. It should be obvious, though, that the value of exports and the value of DISC are independent of business cycles. We need exports, that is we need to be competitive, in good times as well as bad.

We have given thought, as you have asked us to do, to other tax and non-tax incentives to exports, bearing in mind both cost effectiveness and compatibility with the GATT. We have concluded that from a pragmatic standpoint there is no suitable substitute for the DISC. If the times were propitious to consider improvements, we would suggest repeal of the 1975 amendments to DISC. These, as you will recall, have had the effect of reducing by half the value of DISC to exporters.

We conclude with a comment that is made by virtually every businessman who has considered the problem of export incentives. It is the bottom line that motivates business to invest more. The objective is to make exports as profitable as possible. The Treasury analysis of DISC's effectiveness is a marginal price analysis and appropriately, therefore, so is the Price Waterhouse study. Increasing taxes on exports, as the elimination of DISC obviously would, is the surest way to reorder business priorities to the disadvantage of exports. In the real world, prices are not likely to be raised on exports if DISC is eliminated. The risk rather is of the loss of management's long term commitment to exporting. U.S. international competitiveness and U.S. industrial strength would surely suffer as a result.

Very truly yours,

John M. Albertine
American Business Conference

H Richard Kobl
Business Roundtable

Chamber of Commerce of the United States

Emergency Committee for American Trade

National Association of Manufacturers

National Foreign Trade Council

John R. B
Special Committee for U.S. Exports

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Price Waterhouse

EXECUTIVE SUMMARY

The purpose of the Domestic International Sales Corporation (DISC) tax provisions is to enhance the ability of U.S. firms to compete in the world marketplace. The two primary effects of DISC are to:

- Increase export sales by the U.S., and
- Decrease tax receipts from export sales that would have occurred in the absence of DISC.

The U.S. Treasury, in its 1979 DISC Annual Report, estimates the magnitudes of these effects as follows:

- $4.5 to $7.0 billion in DISC-induced export sales, and
- $994 million in reduced tax revenues.

The purpose of the study performed by Price Waterhouse is to examine the economic impacts of DISC, in particular the estimated magnitudes of DISC-induced export sales, and the cost of DISC to the U.S. Treasury.

In brief, our findings are:

- Treasury estimates understate the likely range of values for DISC-induced export sales. Our analysis suggests a range of $1.5 to $7.0 billion, with a moderate response estimate of $5.3 billion.
- Treasury estimates of DISC costs include foregone corporate taxes on both existing and DISC-induced export sales. Since the true cost of DISC is the amount of taxes foregone on existing export sales, the Treasury estimate of the cost of DISC ($994 million) should be reduced by $161 million under a moderate response scenario (to $833 million).

Assuming a moderate response estimate of $5.3 billion in DISC-induced exports, and current slack conditions in the U.S. economy, the following effects are observed:

- $161 million increase in corporate income taxes;
- $451 million increase in personal income taxes; and
- $420 million increase in payroll taxes.

In summary, we conclude that the Treasury estimate of DISC costs of $994 million should be reduced to $833 million and should be further reduced by the following DISC-induced tax collections:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

In other words, rather than costing the taxpayer, DISC actually returns $1.24 to the Treasury for each dollar of tax incentive provided.

Thus, we conclude that the DISC provisions increase U.S. export sales by between $1.5 and 7.0 billion at little or no cost to the Treasury. In fact, under a reasonable set of assumptions, DISC may actually increase both output and total Treasury receipts at a time of low capacity utilization and high unemployment in the U.S. economy.

1. INTRODUCTION AND SUMMARY

This report reviews the economic impacts of the Domestic International Sales Corporation (DISC) tax provisions by assessing their costs and benefits and considering what would happen if DISC were repealed. DISC was enacted in 1971 to stimulate U.S. exports and, thereby, improve our balance of trade. By providing tax deferral on a portion of net income earned from exports, DISC's goal is to enhance the ability of U.S. firms to compete abroad. Many experts recognize that DISC redresses imbalances in tax treatment between U.S. exporters and those in other countries.

While DISC may not be costless, it is also not without its benefits. U.S. Treasury calculations for 1979 suggest that the initial cost of DISC is $1 billion in foregone tax revenues on the income deferred through DISC. When some of the major feedbacks caused by the DISC-induced exports are considered, however, net Treasury tax collections may actually increase.[1] Thus, the American taxpayer may be better off with DISC than without it.

A. Background on the Report

This report has been prepared at the request of several organizations representing U.S. trade interests. Sponsoring organizations include the U.S. Chamber of Commerce; the Business Roundtable; the National Association of Manufacturers; the Emergency Committee for American Trade; the Special Committee for

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[1] A certain amount of exports will occur with and without the DISC incentive. The portion of exports that would not occur in the absence of DISC are referred to as DISC-induced exports.

U.S. Exports; the National Foreign Trade Council; and the American Business Conference. These organizations and the business community have been challenged by Treasury officials to demonstrate the cost-effectiveness of DISC and were asked to prepare a report that quantifies the costs and benefits of DISC. This report was to be completed and transmitted to Treasury by April 15.

Price Waterhouse was asked in mid-March to undertake this cost-effectiveness investigation of DISC. Of necessity, this analysis is preliminary and "broad brushed," given the desire to complete the report by April 15 and avoid premature decisions regarding repeal or modification of DISC. Treasury revenue loss estimates and methods for calculating the export impacts of DISC served as the starting point of the analysis. All figures are based on the Treasury's annual report on the operations and effects of DISC for DISC year 1979.[2] The economic impacts are considered with and without the Accelerated Cost Recovery System (ACRS) enacted in the Economic Recovery Tax Act of 1981.

Through critiquing the Treasury methods and estimates, the study seeks to answer the following questions:

- What is the "true" initial revenue loss associated with DISC?
- What is the range of possible impacts of DISC on U.S. exports?

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[2] See "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981.

- What are the tax revenue implications of the DISC-induced U.S. exports?
- What are the net cost implications of DISC and, conversely, of repealing DISC?

B. Summary of Findings

The partial feedback analysis performed by Price Waterhouse provides the following answers to the above questions.

True Initial Revenue Loss. Treasury estimates that the revenue loss associated with DISC sales of $99.6 billion was $994 million in DISC year 1979. This estimate of revenue loss includes taxes deferred on DISC-induced exports (that is, exports that would not occur in the absence of DISC). Based upon our estimated range for DISC-induced exports discussed below, DISC sales would have ranged between $92.6 and $98.1 billion in the absence of DISC. The "true" initial revenue loss associated with DISC ranges between $779 and $970 million in 1979. The remainder (as compared to the Treasury estimate of $994 million) represents taxes deferred on exports that would not have existed in the absence of DISC.

Impact on Exports. A stated purpose of DISC is to stimulate U.S. exports. By reducing the costs to U.S. exporters via the tax mechanism, DISC improves the ability of U.S. firms to compete in the world market. Treasury estimates the export impact of DISC by assuming that exporters pass the benefits of the tax incentive on to consumers. Given uncertainty regarding price responsiveness in the U.S. export market, Treasury estimates that DISC will induce an increase in the value of U.S. exports of between $4.5 and $7.0 billion. Empirical evidence on price responsiveness is inadequate for accurately providing a point estimate and Price Waterhouse has expanded the range of uncertainty to include lower price responsiveness assumptions than Treasury. Overall, Price Waterhouse estimates that DISC will induce additional exports valued between $1.5 and $7.0 billion. Our moderate price responsiveness case suggests DISC induced exports of $5.3 billion in 1979.

Revenue Feedbacks. The DISC-induced exports will generate additional Treasury revenues. Assuming that resources used in the production of DISC-induced exports were previously unemployed--a plausible assumption in today's economy--and the DISC stimulated exports represent a net increase in the U.S. balance of trade, DISC will add to the aggregate output of the U.S. economy and U.S. tax collections. For example, based on the moderate price response case ($5.3 billion induced exports), Treasury will realize the following changes in several major Federal taxes:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$ 161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

From the corporate income, personal income, and payroll taxes alone, DISC would add $1,032 million to the U.S. treasuries.

Changes in these three major taxes are not the only benefits of DISC. Increases in economic activity reduce many government outlays such as welfare and unemployment compensation and also augment state and local tax collections. Moreover, the quantified feedbacks represent those that occur in the initial round. Indeed, when the "ripple effects" through the economy are considered, these revenue benefits of DISC may be more than doubled.

Net Costs of DISC. When the initial revenue loss is compared to the additional tax collections generated by the DISC-induced exports, the DISC net subsidy is significantly reduced and, under certain assumptions, Treasury is better off with DISC than without it. Based on the export impacts described above, the ratio of additional revenues from feedbacks (benefits) to initial revenue loss (costs) range from .29 to 1.76. The moderate price response case suggests a ratio of 1.24. In other words, for every dollar spent on DISC in terms of revenues foregone, the Treasury receives $1.24 in additional revenue collections. Thus, by eliminating DISC, Treasury revenues would decline by $199 million.

According to Treasury, the effect of the Accelerated Cost Recovery System (ACRS)[3] on DISC is to reduce both revenue losses and export impacts by the same percentage or approximately 27 percent. Thus, had ACRS been fully implemented in DISC year 1979, elimination of DISC would still cost the Treasury $146 million.

C. Outline of the Report

The rest of this report reviews in more detail the costs and benefits of DISC and is organized as follows:

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3. Established under the Economic Recovery Tax Act of 1981.

- Section II--Background on DISC. This section describes the DISC tax provisions and how they have changed over the decade. Particular attention is given to the relationship between DISC and ACRS.

- Section III--The Export Impact of DISC. This section identifies changes in U.S. exports as a major source of the benefits derived from DISC. Using the Treasury method, export impact estimates are provided under several price responsiveness assumptions.

- Section IV--The Costs and Benefits of DISC. In this section, a partial feedback analysis is performed to assess the net cost implications of DISC. The section begins with a discussion of the advantages and disadvantages of various methods for tax incentive analysis. In this context, the Treasury revenue loss estimates are critiqued. Finally, using the Treasury initial revenue loss figures, a partial feedback analysis is performed.

- Section V--Some Economic Impacts of DISC in a General Equilibrium Framework. In this section, the implication for DISC impacts in a more general framework are considered. Specifically, this section discusses two issues: First, the potential impact of DISC on the balance of trade through changes in the exchange rate; and second, changes in economic efficiency that may result when resources used in the production of DISC exports have been diverted from elsewhere in the U.S. economy.

- Section VI--The Effects of Eliminating DISC. This section reviews the costs and benefits of DISC and summarizes the revenue implications of repealing the DISC provisions. These revenue implications are considered before and after the full implementation of ACRS.

II. BACKGROUND ON DISC

This section discusses the manner in which the DISC provisions provide an incentive to earn export income. The section is arranged in two subsections:

- DISC Provisions and Changes
- The Economic Recovery Tax Act of 1981

The first subsection describes the tax benefits of DISC and reviews the evolution of the program. The second subsection explains briefly the effect of recent tax changes--which do not directly change the DISC program--on the costs and benefits of DISC.

A. DISC Provisions and Changes

In 1971, the United States was faced with its largest balance of payments deficit in history. In response to this crisis, a series of steps were taken. First, official gold sales were halted and the dollar was devalued against foreign currencies. Second, a temporary tariff or surcharge was instituted on imported commodities. Third, the Domestic International Sales Corporation (DISC) program was enacted, effective for 1972. DISC created a tax incentive to earn export income, thus encouraging U.S. corporations to enter and expand their positions in the export market. The program was designed not only to encourage sales to foreign consumers but, more importantly, to encourage U.S.-based production.

The DISC incentive was created by the Revenue Act of 1971. Taxpayers are permitted to establish corporations (called Domestic International Sales Corporations) to conduct their export activities. Under the Act, the DISC legislation provides deferral of federal income tax on 50 percent of the export earnings allocated to the DISC, with the balance treated as dividend to the parent company. (The portion of the export income allocated to the parent company is taxed in the normal manner.) To qualify for the tax deferral, a DISC must meet several criteria including:

1. The DISC must be incorporated in the United States and have no more than one class of stock, and par or stated value of the stock must be at least $2,500 each day of the taxable year.
2. The DISC must obtain 95 percent or more of its receipts from "qualified exports receipts."[4]

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[4] In general, qualified receipts are generated from the sale or lease of "export property" (defined in footnote 5 below) or commissions from these export transactions. Other qualified receipts include interest income from a qualified export asset, service income "related and subsidiary" to the sale or lease of export property and service income from engineering or architecture services with respect to foreign construction projects.

3. At least 95 percent of the DISC's assets must be "qualified export assets."[5]

As noted, DISC must distribute, or be treated as distributing, a portion of its export earnings to its shareholder(s) each year. The export income of a DISC, which arises from transactions with a related supplier, can be calculated in one of three ways:

1. Four percent of the receipts from the sale of export property plus ten percent of export promotion expenses;
2. Fifty percent of the combined taxable net export earnings of the DISC and related supplier plus ten percent of export promotion expenses, which can be applied on a marginal costing basis in certain circumstances; or
3. The net export earnings of the DISC based on the price actually charged if the price is based on an arm's-length transaction.

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[5] Some common qualified assets include "export property," assets used primarily in connection with the sale or lease of export property, accounts receivable arising in connection with export transactions, so-called "producer loans," and money and temporary investments to the extent reasonably needed to meet working capital requirements.

"Export property" is defined as property manufactured, produced, grown or extracted in the United States by a person other than a DISC. Such property must be held primarily for sale, lease or rental by or to a DISC for direct use or consumption outside the United States. In addition, not more than 50 percent of the fair market value of the property can be attributable to articles imported into the United States.

The income so determined, plus any other income which a DISC may earn, is then subject to the required distribution (or deemed distribution) rules. The remainder of the income may be retained by the DISC as tax deferred income as long as the DISC qualifications are maintained.

The Tax Reduction Act of 1975 removed the tax deferral for export earnings attributed to the sale of products in short supply in the U.S. and also removed DISC benefits for earnings from certain natural resources. The Tax Reform Act of 1976 added an additional requirement that tax deferral benefits could be applied only to incremental sales. The incremental sales requirement is as follows: For taxable years beginning after December 31, 1975, deferral treatment is permitted only for income from export gross receipts exceeding 67 percent of average export gross receipts during a four-year base period. Accordingly, 100 percent of the income attributable to non-incremental exports is deemed distributed to the parent company, while 50 percent of the income attributable to incremental exports is deemed distributed. DISCs with income of $100,000 or less are not affected by this incremental provision. In addition, the 1976 Act reduced tax deferral attributable to sales of military goods.

B. The Economic Recovery Tax Act of 1981

The effect of DISC is to reduce the cost of capital used in producing export goods. The Economic Recovery Tax Act of 1981, however, by liberalizing depreciation allowances in calculating federal income tax liability, has reduced the effective tax rate and lowered the cost of capital for both the domestic and export sectors. Briefly, the Accelerated Cost Recovery System (ACRS) has replaced the Class Life Asset Depreciation Range (CLADR) system. By accelerating the depreciation of property, ACRS permits larger deductions in the initial years of an investment.

Permitting depreciation allowances to be claimed earlier in the life of the investment increases the net present value of an after-tax stream of returns. A higher net present value given a fixed cost of capital, increases the likelihood that an investment project will be undertaken. Alternatively, the effect of ACRS can be viewed as reducing the cost of capital relative to a fixed stream of returns.

Because ACRS is applied to all firms, regardless of the destination of their final products, the relative tax advantage of DISC has been diminished. DISC is a tax incentive valued at a fixed percentage of taxable income. As ACRS reduces taxable income, the DISC program is relatively less beneficial to exporters and relatively less costly to the Treasury.

To demonstrate the effect of ACRS on DISC, one study calculated the effective tax rate for a typical, although hypothetical, manufacture-for-export project.[6] These results are shown in Table II-1.

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[6] Thomas Horst, "The Impact of DISC, ACRS, and the Proposed FISC Rules on the Effective Tax Rate for Export Income," Tax Notes, November 16, 1981.

Table II-1

EFFECTIVE TAX RATES UNDER
ALTERNATIVE TAX SYSTEM 7

	CLADR Rules	ACRS Rules
Without DISC	28.3%	24.3%
With DISC	20.8%	17.6%

These tax rates significantly affect firms' decisions to invest. Assume that a firm requires an after-tax return of 15 percent to undertake an investment. Using the study's calculations, the 15 percent after-tax return requires the before-tax rates of return illustrated in Table II-2.

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7. Horst defines the effective tax rate as the percentage reduction in the internal rate of return of the project due to taxes.

Table II-2

BEFORE TAX RATE OF RETURN REQUIRED TO OBTAIN AN
AFTER TAX RATE OF RETURN OF 15 PERCENT UNDER
ALTERNATIVE TAX SYSTEMS

	CLADR Rules	ACRS Rules
Without DISC	20.92%	19.81%
With DISC	18.94%	18.20%

Two important points are apparent from Table II-2. First, this typical exporter is better off with DISC and without ACRS than with ACRS and without DISC. Second, ACRS provides greater benefits to firms without DISC (such as firms that produce for domestic consumption) than it provides to firms with DISC. This advantage is apparent both in absolute and in relative terms.

Under the ACRS system, we conclude that DISC will lose some of its effectiveness in promoting export production relative to production for domestic use. However, the cost of DISC to the Treasury will also decline.

III. THE EXPORT IMPACT OF DISC

The purpose of the DISC provisions is "to increase our exports and improve our balance of payments."[8] Besides inducing an increase in exports, other benefits can also be ascribed to DISC. These potential benefits include increases in corporate earnings (and the taxes thereon) from the induced exports, increases in personal income through job creation, increases in the economic growth rate, and reductions in unemployment compensation and other transfer payments.

In order to estimate any of these possible benefits, however, the initial impact of DISC on increasing U.S. exports must first be determined. In this section, we evaluate the method used by the Treasury to estimate the impact of DISC on U.S. exports for DISC year 1979 (as reported in the 1979 Annual Report on DISC released by Treasury in April 1981). Based on our analysis of the demand and supply elasticities available from Treasury and other sources, we propose a range of likely outcomes for the level of exports induced by the DISC tax provisions. In Section IV, these results are used to develop measures of cost-effectiveness for DISC.

A. Measuring Changes in U.S. Exports--The U.S. Treasury Method

The U.S. Treasury was charged by Congress with the annual production of a report that analyzes the effect of the DISC provisions. These annual reports, starting with 1972 and most recently for 1979, have attempted to quantify the increase in exports attributable to DISC. For DISC year 1979, the Treasury estimates that DISC accounted for between $4.5 and $7.0 billion in increased U.S. exports at a cost to the Treasury of nearly $1.0 billion in reduced receipts from corporate income taxes.

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[8] H.R. Rep. No. 533, 92nd Cong., 1st Sess. 1 (1971); S. Rep. No. 437, 92nd Cong., 1st Sess. 1 (1971).

In earlier annual reports, the Treasury attempted to infer the level of DISC-induced exports by comparing the growth of DISC and non-DISC exports. In an era that included rapid increases in both U.S. exports and world trade, high inflation rates, and floating and sometimes volatile exchange rates, the attribution of differential growth rates for exports in these two categories to the DISC provisions alone is questionable. In addition, problems concerning the derivation of DISC and non-DISC export volumes resulted in a high sensitivity of these estimates to errors in the trade data.

Recognizing these difficulties, the Treasury implemented two changes in estimating DISC-induced exports in the 1979 Annual Report. The first change was in the method employed. The new method is basically a supply-demand analysis for four broad categories of exports that relies critically on estimates of the supply and demand elasticities for each category. The second change is the recognition of the uncertainty involved in estimating elasticities, and hence in the ultimate export estimates. The Treasury now provides a range of export estimates to reflect the uncertainty in the assumed elasticity values.

Through the mechanism of increasing the after-tax profitability of exports, DISC induces an increase in the amount of exports that producers will supply at a specific price. This shift in the export supply schedule, combined with both demand and supply responses, generally results in a higher quantity of exports sold, a somewhat lower price for those exports, and higher values for both the total value of exports and export profits. The magnitude of these changes depends on the degree of shift in supply schedules and responsiveness of both supply and demand to changes in price, as summarized by supply and demand elasticities with respect to price.[9]

The change in total export revenue associated with a tax benefit of X dollars is given by the formula below:

$$\Delta TR = \left[\frac{X}{1-t}\right] \left[\frac{(E_d - 1)\, E_s}{E_s + E_d}\right]$$

where ΔTR equals change in total export revenue, t is the marginal corporate tax rate and E_d and E_s are demand and supply elasticities, respectively. The first term represents the effect (or "gross-up") of the change in tax liabilities on the revenue needed by a producer to generate a specific, after-tax rate of return. The second term represents the reaction of supply and demand to a shift in the supply schedule.[10]

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[9] The price elasticity of demand (supply) is the percentage change in quantity demanded by (supplied to) consumers due to a unit percentage change in price.

[10] This reaction can be decomposed into two effects: (1) the increase in revenue due to the increase in sales at the new price, and (2) the decrease in revenue due to the reduction in price received on existing sales. Given the values assumed by Treasury for supply and demand elasticities, the net effect is an increase in total revenue.

In applying this formula, the Treasury uses the following procedure:

- Classification of DISC exports into four categories of products;
- Calculation, for each category, of the average value of tax deferrals per dollar of sales;
- Application of the formula to each product category using the appropriate marginal tax rate (48 percent for DISC Year 1979);
- Finally, multiplication of the percent change in value of exports for each category by the sales in each category and summation over categories to yield the total DISC-induced increase in exports.

B. Elasticity Assumptions

The key determinants of the export impact of DISC are the specific values assumed for the supply and demand elasticities. For this reason, an analysis of the Treasury's assumed elasticity values is essential in evaluating its estimates of DISC's impact.

Several empirical studies have been performed in an attempt to estimate supply and demand elasticities for U.S. exports. However, four major sources of error are often cited in connection with the reliability of available elasticity estimates:

- Aggregation bias;
- Simultaneous equation bias;
- Errors in variables; and
- Misspecification.

What is important with respect to these errors is that, with the exception of errors in variables (which biases the estimates downward), the direction of their effect is unknown. At a minimum, they introduce some uncertainty with respect to the precise magnitude of elasticity estimates.

1. U.S. Treasury Elasticity Estimates

Table III-1 presents the elasticities of demand and supply used by the Treasury in the 1979 Annual Report. The assumed supply elasticities are high because Treasury assumes that the "supply of output to foreign markets is extremely responsive since it represents the diversion of output from domestic consumption, which can be instantaneous."[11] Another argument for high supply elasticities (unstated by the Treasury) can be made in light of current economic conditions--that with high unemployment and excess manufacturing capacity, the supply of output for either domestic consumption or export is very responsive, with no diversion necessary. The relatively low supply elasticity for non-manufactured goods (mainly agricultural goods) is assumed to result from resource constraints.

Demand elasticities are assumed by Treasury to vary among the "...product categories, depending on the differentiation of products in world trade. Some products, including agricultural goods are highly standardized, and foreign demand is therefore highly elastic."[12]

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[11] 1979 Annual Report, p 2.

[12] Ibid., p 2.

Table III-1

ELASTICITIES OF SUPPLY AND DEMAND ASSUMED
BY U.S. TREASURY IN 1979 ANNUAL REPORT

	Product Category	Supply Elasticity	Demand Elasticity (absolute values)
1.	Nonmanufactured Products	1.5-2.5	Infinite
2.	Basic Manufactures	20	6-8
3.	High Technology Manufactures	20	3-5
4.	Resource Related Manufactures	4	8-10

Source: "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981.

While Treasury's elasticity estimates seem reasonable at the level of the individual firm (or producer) they are probably inappropriate for an evaluation of aggregate demand. To illustrate this point, consider the demand elasticity cited for non-manufactured goods. These goods are mainly from the agricultural sector (about 95 percent were agricultural goods in DISC year 1979). It is true that demand elasticities are extremely high for individual producers (since they function within a nearly "perfectly competitive" market). However, the aggregate demand for these goods is in fact highly inelastic.[13]

Although the infinite elasticity of demand for non-manufactured goods is probably high, the supply elasticity assumed by the Treasury for this sector may be too low because resource constraints on this sector as a whole are less of a factor than they would be for individual firms. This argument is probably also relevant (although, to a lesser degree) to the "resource-related manufactures" sector.

2. Alternative Elasticity Estimates

Tables III-2 and III-3 present examples of supply and demand elasticities for U.S. exports cited in the literature. Most of the available estimates are for demand elasticities, and nearly all are at a more aggregate level than the four categories considered by Treasury.

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[13] A highly inelastic aggregate (worldwide) demand elasticity for agricultural goods need not necessarily imply an inelastic aggregate demand elasticity for U.S. exports (see Artus and McGuirk, IMF Staff Papers, June 1981). It would be inconsistent with an infinite demand elasticity for these exports, however.

Table III-2

U.S. EXPORT SUPPLY ELASTICITIES CITED IN THE LITERATURE

Source	Supply Elasticity
Goldstein - Khan[1]	
Equilibrium model	6.6
Disequilibrium model	3.9
Geraci - Prewo[2]	12.2
Magee[3]	11.5

1. Goldstein, M. and M.S. Khan, "The Supply and Demand for Exports: A simultaneous Approach," Review of Economics and Statistics Vol. 60, May 1978.

2. Geraci, V.J. and W. Prewo, "An Empirical Demand and Supply Model of Multilateral Trade," Discussion Paper 80-1, University of Texas, March, 1980.

3. Magee, S.P., "Prices, Income and Foreign Trade," in P.B. Kenen (ed.), International Trade and Finance: Frontiers for Research, Cambridge University Press, 1975.

Table III-3

U.S. EXPORT DEMAND ELASTICITIES
CITED IN THE LITERATURE

Source	Demand Elasticity (absolute value)
Goldstein-Khan[1] (FIML)	2.32
Goldstein-Khan (OLS)	2.13
Hickman-Lau[2]	1.51
Houthakker-Magee[3]	1.51
Artus-McGuirk[4]	
Food	2.0
Crude Materials	2.0
Fuels	2.0
Semifinished Manufacturing	1.5
Finished Manufacturing	1.75
Horst (short-run)[5]	1.5 to 3.0
(long-run)	3.0 to 5.0
Deppler-Ripley (short-run)[6]	0.29
(cumulative)	1.52
Basevi (short-run)[7]	0.49
" " (long-run)	1.44
Stone[8]	
Method I	1.59
Method II	1.26

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1. Goldstein, M. and M.S. Khan, "The Supply and Demand for Exports: A Simultaneous Approach," Review of Economics and Statistics Vol. 60, May, 1978. "FIML" are estimates derived through full-information maximum likelihood method. "OSL" are estimates denied using ordinary least squares.

2. Hickman, B.G. and L.J. Lau, "Elasticities of Substitution and Export Demand in a World Trade Model," European Economic Review, Vol. 4, December, 1973.

3. Houthakker, H.S. and S.P. Magee, "Income and Price Elasticities in World Trade," Review of Economics and Statistics, Vol. 51, May, 1969. Price elasticities of agricultural and non-agricultural exports were found to be similar.

4. Artus, J.R. and A.K. McGuirk, "A Revised Version of the Multilateral Exchange Rate Model," IMF Staff Papers, Vol. 28, No. 2, June, 1981. Price elasticities derived by assumption.

5. Horst, T., "An Economic Analysis of the Foreign International Sales Corporation Proposal," unpublished, September, 1981. Price elasticities derived by assumption.

6. Deppler, M.C. and D.M. Ripley, "The World Trade Model: Merchandise Trade," IMF Staff Papers, Vol. 25, No. 1, March, 1978. Cumulative equals short-run plus "long-run."

7. Basevi, G., "Commodity Trade Equations in Project LINK," in R.J. Ball (ed.), The International Linkage of National Economic Models, American Elsevier Publishing Co., 1973.

8. Stone, J.A., "Price Elasticities of Demand for Imports and Exports: Industry Estimates for the U.S., the E.E.C. and Japan," Review of Economics and Statistics, Vol. 61, May, 1979. Greater sectorial detail is available from this source.

Of the few estimates of supply elasticities, most are very high (Goldstein and Khan favor the higher estimates of their equilibrium model). In light of this, the Treasury estimates appear reasonable (except that, as mentioned above, the supply elasticity for nonmanufactured products appears to be too low). In addition, the estimates presented are not inconsistent with the assumptions used by other multilateral trade analysts, i.e., that supply elasticities, especially where considerable slack productive capacity exists, are extremely high or infinite.

The demand elasticities in Table III-3 provide less support for those used by the Treasury. Most of the empirically-derived estimates of demand elasticity cluster around 1.5, and the largest empirically derived value is 2.32. This is much smaller than the estimates used by the Treasury (except in the case of "high technology manufactures"). Horst, citing the downward bias in these estimates resulting from statistical factors, assumes long-run elasticities of between 3 and 5.

On the basis of the empirical evidence, it would appear that the Treasury has probably overstated long-run demand elasticities for U.S. exports. Given the other estimates available and the range of uncertainty associated with them, we have taken the approach of performing a sensitivity analysis using three demand elasticity cases, corresponding to low, moderate, and high response scenarios. The values used by the Treasury were used to define the "high response" scenario. Horst's elasticity estimates were used to define the "moderate response" scenario. Other empirical estimates (principally Goldstein-Khan) were used to define the "low response" scenario. Demand elasticities for all scenarios are presented in Table III-4.

Table III-4

ELASTICITIES OF SUPPLY AND DEMAND FOR LOW, MODERATE, AND HIGH RESPONSE SCENARIOS

Product Category	Supply Elasticity Scenario			Demand Elasticity Scenario (absolute value)		
	Low	Moderate	High[1]	Low	Moderate	High[1]
1. Nonmanufactured Products	4	10	2.5	2	5	Inf.
2. Basic Manufactures	10	20	20	2	5	8
3. High Technology Manufactures	10	20	20	2	4	5
4. Resource Related Manufactures	4	10	4	2	5	10

1. Treasury elasticity assumption for its high response case.

As stated above, the supply elasticities used by Treasury appear reasonable except in the cases of nonmanufactured goods and resource-related manufactures, where they may be too low. A range of 4-10 for these two sectors is more appropriate. However, for the high demand elasticity response scenario, we adopted the supply elasticities that were used by Treasury. Two other scenarios for supply elasticities were used ("low and moderate response"). Scenario-specific supply elasticities are also shown in Table III-4.

C. Results of the Scenarios

Presented in Table III-5 are the implied increases in exports induced by DISC for the low, moderate, and high response scenarios. These DISC-induced exports are assumed to consist mainly of increases in output rather than diversions from domestic consumption. This result is based on the following assumptions:

- Given an adequate supply of dollars worldwide, capital invested in export production is not diverted from domestic uses.
- The current economic situation is characterized by considerable slack in the labor market and in the utilization of productive capacity. Under these conditions it is less likely that DISC-induced increases in exports will displace either capital or labor from domestic uses.

Increases in exports induced by DISC under the three response scenarios are summarized below:

Table III-5

INDUCED EXPORTS--LOW, MODERATE AND HIGH RESPONSE SCENARIOS

Products Category	Receipts (billions)	DISC Saving per $ of Sales	Increase in Value of Exports (in billions)[1]		
			Low Response	Moderate Response	High Response
1. Nonmanufactured Products	$ 26.038	.314%	$ .105	$ .419	$ .394
2. Basic Manfactures	29.898	1.030	.494	1.895	2.961
3. High Technology Manufactures	35.639	1.489	.850	2.551	3.266
4. Resource Related Manufactures	8.027	.948	.098	.390	.376
Total	$ 99.602	1.028%[1]	$ 1.547	$ 5.255	$ 6.997

1. Derived percent average DISC saving per dollar of sales, not a total.

Scenario	Value of DISC-Induced Exports ($ in billions)
Low Response	$1.5
Moderate Response	$5.3
High Response	$7.0

These results, ranging from a low of $1.5 billion to a high of $7.0 billion, cover a wider range of induced-export values than does the Treasury estimates. This reflects our feeling that the supply and demand elasticities are fraught with greater uncertainty than recognized by the Treasury estimates.

It should also be pointed out that these estimates reflect tax provisions in effect in DISC year 1979, and thus do not reflect implementation of the ACRS provisions of the Economic Recovery Tax Act of 1981. As we argued in Section II, at an aggregate level, ACRS reduces both the costs and benefits of DISC proportionally, although it may have a differential impact on some exporters given differences in existing capital stock.

IV. THE COSTS AND BENEFITS OF DISC

The purpose of this section is to provide a quantitative assessment of the net costs to the Federal government of the DISC provisions. For purposes of this analysis, net costs are measured as the change in tax revenues to the U.S. Treasury resulting from the deferral of corporate income taxes on a portion of profits earned from exports. Such a net cost measure must consider not only the lost tax revenues (costs) associated with DISC deferral but also the possible increased Treasury revenues (benefits) associated with the additional economic activity induced by the DISC incentive.

The U.S. Treasury, in estimating the revenue loss associated with DISC, considers only the tax losses due to the DISC deferral and not the possible revenue gains from increased economic activity. Under Treasury's method, DISC is estimated to cost U.S. taxpayers $994 million in DISC year 1979. However, when increased revenues due to the DISC-induced exports are considered, from 29 to 176 percent of the DISC costs may be recovered by Treasury. Thus, the net costs of DISC to the Federal government may be significantly reduced and may under certain assumptions produce a net benefit; that is, rather than incurring only costs, the Treasury may also collect an additional $281 to $1,374 million in revenues when exports are encouraged through DISC.

This section includes the following subsections:

- A discussion of the methods for measuring the net costs of DISC;
- A review and critique of the Treasury estimates of DISC costs; and

- A quantitative example of the net costs of DISC when feedbacks from DISC-induced exports are considered.

A. Methods of Measuring the Net Costs of DISC

There are essentially three general approaches to measuring the costs of a tax incentive. At the one extreme is the most complete approach which views the tax incentive in the context of total economic activity and calculates the net changes caused by the incentive. A second less general approach is to isolate some of the major cost implications of a tax incentive by considering some behavioral responses and initial feedbacks on Treasury revenues and other Federal government outlays. The third and least general approach is one which looks at the tax incentive in total isolation without considering behavioral responses or any revenue feedback implications.

These three general methods may be categorized to the extent they account for the complex set of interactions caused by a tax incentive as follows:

- Full feedback (or general equilibrium) analysis;
- Partial feedback analysis; and
- No feedback analysis.

Each of these methods has some obvious strengths and weaknesses.

The full feedback approach is the theoretically correct method for net cost analysis, but it is often impossible to implement in its purest form. Full feedback analysis provides the most complete picture of economic activity with and without a tax incentive. Such an analysis would consider not only the complex interactions that occur at any point in time but also how these economic interactions may change overtime and their associated feedbacks. While many of the macro and micro models attempt to capture this complexity, they are at best first approximations and too crude to analyze the impacts of a program with effects as complicated as those of DISC. Thus, the strength of the full feedback approach--an identification of the complex interactions necessary for true net cost analysis--is also its chief weakness since data and modeling limitations preclude its full application.

The partial feedback approach attempts to quantify the major feedbacks associated with responses to a tax incentive. Partial feedback analysis includes quantification of some of the following:

- Net changes in Federal, state, and local taxes due to direct and indirect impacts on economic activity;
- Net changes in taxes from balance of trade adjustments associated with induced changes in exports and imports;
- Net impact on tax revenues through changes in the general price level caused by the funding mechanism for the tax provision (i.e., increased government borrowing); and
- Changes in government outlays such as various transfer benefits that may be indirectly affected by the tax incentive.

Each of these major impacts involves complex sets of interactions many of which occur simultaneously.

The major weakness of the partial feedback approach is that it is by definition partial. Thus, not all potential impacts are quantified and the result may be affected by the types of feedbacks that are quantified. Some of the non-quantified or "nonquantifiable" feedbacks may be significant and could alter conclusions. Moreover, given behavioral uncertainties and data limitations, quantification requires numerous explicit and implicit simplifying assumptions about the environment in which the tax incentive is evaluated. Whether performed with a sophisticated model or on the back of an envelope, the final result from a partial feedback analysis must be considered suggestive and not predictive. The results must be evaluated according to the reasonableness of the assumptions and with a recognition of the sensitivity of the results to other feedbacks that may or may not be easily quantifiable.

The no feedback approach is probably the least useful of the three approaches for assessing the net costs of a tax incentive.[14] This approach views the tax incentive in isolation and answers the question of how Treasury revenues would change if the incentive item were subject to taxation and there were no behavioral responses. The major attraction of this approach is that it involves a rather straightforward calculation that can be applied unambiguously to a variety of tax incentive programs.[15] Its major weakness, of course, is that there are many feedbacks, some obvious, that could significantly alter the net cost assessment of a tax incentive such as DISC.

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[14] The Treasury tax expenditure estimates discussed in the next section are examples of the no feedback approach.

[15] Each year, both the executive and legislative branches do such mechanical calculation when they attempt to quantify numerous tax expenditures as part of the Federal budget evaluation process.

In the final analysis, the full feedback approach, although theoretically pure, is impossible to implement. The no feedback approach is too restrictive in its no feedback assumption and is therefore indefensible as a measure of net costs. Partial feedback analysis strikes a compromise between these two extremes.

B. Treasury Estimates of DISC Costs

The Secretary of the Treasury issues annually a report to Congress that describes the operations and effects of DISC.[16] This report includes detailed revenue impact estimates of DISC for the report year based upon a sample of DISC returns and also forecasts DISC revenue impacts for future years. The latest report estimates the revenue loss associated with DISC to be $994 million for DISC year 1979. With the publication of an annual report (seven to date), DISC is probably one of the most carefully reviewed and analyzed tax provisions in the Federal budget. This remains true even though there are many others that are much larger in dollar terms.

1. Treasury Method

The U.S. Treasury employs the no feedback approach to estimate the DISC revenue loss. Treasury calculates the Federal revenues foregone by the deferral of DISC income from the corporate profit tax. The calculation is performed by applying the marginal corporate income tax rate to the deferred income as measured from a sample of DISC returns.[17] For example, in DISC year 1979 (calendar year 1978 income) 7,208 DISC returns reported $99.6 billion in gross receipts and $6.4 billion in net income. The tax deferral component of this net income for DISC was $2.1 billion and thus the taxes foregone as estimated by Treasury were $994 million (i.e., $2.1 billion times .48).

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[16] See "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1979 Annual Report," U.S. Department of the Treasury, April 1981.

To estimate revenue losses, Treasury treats DISC as a "tax expenditure" and performs a mechanical calculation which is consistent with tax expenditure analysis as required under law, to be performed by agencies in both the executive and legislative branches of government.[18] This "static" (no feedback) analysis involves several restrictive assumptions:

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[17] The marginal tax rates used in these calculations were 48 percent for calendar years 1972-1978 and 46 percent for 1979 and subsequent years. DISC Year 1979 is essentially calender year 1978 income.

[18] The Congressional Budget Act of 1974 requires the executive and legislative branches to list and estimate tax expenditures in the Federal budget. Tax expenditures are defined in the Act as ". . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax or deferral of tax liability." By this definition, both branches of government have listed DISC among the Federal tax expenditures. For example, see "Tax Expenditures," Special Analysis G, The Budget of the United States Government, 1983; "Estimates of Federal Tax Expenditures for Fiscal Years 1982-1987," Joint Committee on Taxation, U.S. Congress, March 8, 1982; and "Tax Expenditures: Current Issues and Five-year Budget Projections for Fiscal Years 1982-1986," Congressional Budget Office, U.S. Congress, September 1981.

- No other features of the tax system change;
- Individuals or businesses do not alter their behavior as a result of the tax expenditure elimination;
- There are no policy changes that mitigate the effects of removing the tax expenditure; and
- There are no indirect feedback effects in terms of economic activity that may alter Treasury tax revenues and government budget outlays.

The Treasury DISC cost calculation is illustrated graphically in Figure IV-1. With the DISC tax deferral, total exports are shown as quantity Q_1, the price of these exports is represented by P_1, and the dollar value of these exports (gross income) is represented by rectangle P_1AQ_1O. The revenue loss on DISC deferred income is represented by rectangle P_1ABP_3.

2. Limitations of the Treasury Method

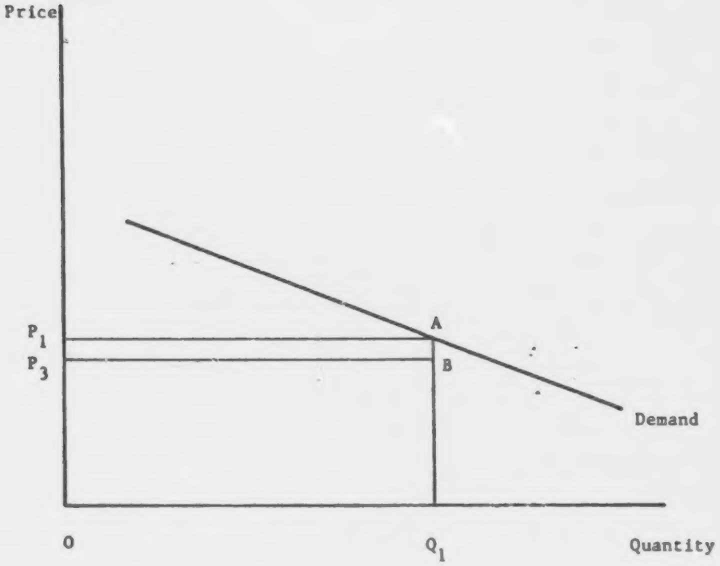
The Treasury revenue loss estimates for DISC are flawed for the purpose of net cost calculation in three general areas:

- Overstatement of Direct Revenue Losses from taxes avoided on DISC income;
- Omission of Indirect Revenue Gains from increased economic activity caused by DISC; and
- Omission of Indirect Impacts on budget outlays associated with changes in economic activity caused by DISC.

Direct Revenues Losses. By its own admission, Treasury indicates that its revenue loss estimates of DISC may be different from the true cost of DISC. One reason for the divergence is the assumption that there is "no behavioral

Figure IV-1

MARKET FOR U.S. EXPORTS
WITH DISC



response" to the DISC incentive in the Treasury revenue loss calculation. Yet Treasury states that "in reality, economic responses may make the true revenue cost [of DISC] different from the $994.2 million estimate [for DISC year 1979]."[19]

This "no behavior response" assumption is inconsistent with Treasury's own assumptions and calculations regarding the responsiveness of exports to the DISC incentive. Assuming that demand and supply for U.S. exports are sensitive to price (i.e., elastic) Treasury estimated that the DISC incentive increased the dollar value of U.S. exports by between $4.5 to $7.0 billion. Our own estimates establish a range of $1.5 to $7.0 billion as the value of exports induced by DISC. Yet, the revenue effects of these increases are not properly accounted for in Treasury's own DISC revenue loss calculations.

A simple example will help demonstrate the potential bias in the Treasury estimates. Figure IV-2 illustrates some of the changes that must be considered in identifying the true cost of DISC.

In the absence of DISC, exporters would charge a higher price for their goods to recover the same income otherwise deferred through DISC. With DISC, the tax benefit per unit of output sold on the world market is P_1-P_3. Without DISC, U.S. suppliers

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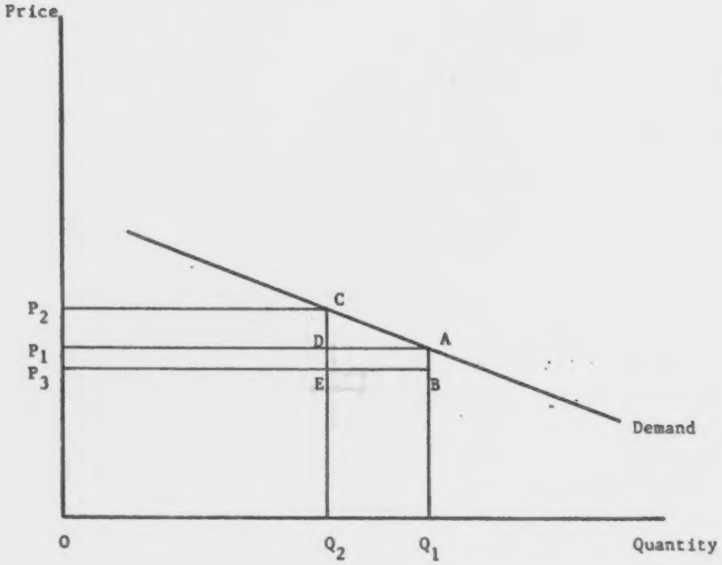
[19] 1979 Annual Report, p. 18.

Figure IV-2

MARKET FOR U.S. EXPORTS
WITH AND WITHOUT DISC



charge a price per unit of P_2 to realize the same after tax rate of return. This higher price reflects the additional cost of income no longer deferred through DISC.[20]

Assuming a downward sloping demand curve for U.S. exports, a rise in the price leads to a reduction in the quantity of U.S. goods sold in the world market. In this example, without DISC U.S. suppliers price their goods at P_2 which leads to a reduction in the quantity demanded to Q_2; the value of U.S. exports falls to the area represented by rectangle P_2CQ_2O (assuming that demand is price responsive, i.e., elastic). The corporate tax on this additional income is obtained by applying the marginal tax rate to rectangle P_2CDP_1. This additional tax revenue, approximately equal to the area of rectangle P_1DEP_3, represents the "direct" revenue losses associated with DISC.

Figure IV-2 illustrates the bias of the Treasury "no behavior response" assumption in their DISC revenue loss estimates. Treasury obtains its "direct" revenue loss estimate as rectangle P_1ABP_3. With the reduction in exports associated with the elimination of DISC, however, the true "direct" revenue loss caused by DISC is rectangle P_1DEP_3. In other words, Treasury overestimates revenue losses by including taxes on DISC deferred income from exports induced by DISC; that is, the rectangle

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[20] In terms of Figure IV-2, $P_2-P_1 = (P_1-P_3)/(1-t)$, where t is the marginal tax rate on corporate income.

DABE.[21] Counting these revenues as part of the cost of DISC is inappropriate since they would not exist in the absence of DISC.

Indirect Revenue Effects. The Treasury tax loss estimates do not reflect the indirect revenue effects of DISC induced changes in economic activity. Under certain conditions, particularly when there are unemployed resources in the economy, Treasury may recover some of the initial revenue loss of the DISC tax incentive. These feedbacks or revenue benefits may be the result of taxes collected on income from DISC-induced economic activity. If DISC-induced exports increase national income, then the Treasury will realize additional corporate and personal income taxes and other revenues will be generated including payroll taxes and various state and local taxes.

The previous example illustrates the offset principle when exports are induced by DISC. As indicated in Figure IV-2, DISC increases the level of U.S. exports from Q_2 to Q_1. Assuming demand is elastic, the total value of U.S. exports will increase; that is, rectangle DAQ_1Q_2 is greater than rectangle P_2CDP_1. The value of this difference will increase with greater price sensitivity (i.e., higher elasticities). Recall that rectangle DABE represents the DISC revenue loss on DISC-induced exports. Therefore, rectangle EBQ_1Q_2 represents additional income that may be taxed and will provide Treasury with additional revenues and reduce the cost of DISC. For example, DISC rules only allow 50 percent of net income on incremental receipts to be deferred leaving the Treasury with corporate taxes on the remaining income from DISC-induced exports. The DISC-induced exports will also increase total wages and salaries on which the Treasury will collect additional personal income taxes and, to the extent that unemployment or underemployment exist in the absence of DISC, Treasury will realize additional payroll taxes.

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[21] This simple example assumes that resources used in the production of DISC exports are not diverted from elsewhere. Such an assumption is reasonable in an economy with excess capacity and unemployed resources as is the case with the current U.S. economy.

Budget Outlay Effects. A net increase in exports may also lead to reductions in some Federal outlays. In particular, it is possible that the Federal government may spend less on transfer programs as a result of the employment induced by DISC. It is obvious that unemployment insurance costs may decline but equally important, though less obvious, may be the savings in some welfare programs such as Food Stamps and Aid to Families with Dependent Children.

To summarize, the Treasury revenue loss estimates for DISC are "static" and do not consider the variety of responses that may occur as a result of the tax incentive. Among the most important is the increased economic activity stimulated by the DISC incentive. In performing a "direct revenue" loss calculation Treasury counts as part of the loss deferred taxes from DISC-induced exports, a clear overstatement of DISC costs. Though by Treasury's own estimates DISC increases exports, Treasury does not calculate the indirect revenue increases associated with these exports. These revenues obviously reduce the cost of DISC. Finally, though difficult to quantify, the Treasury estimates do not reflect outlay savings in various transfer programs from increased output under DISC.

C. A Quantitative Example of Net Costs

For DISC year 1979, Treasury estimates that DISC cost the taxpayers $994 million in foregone revenues in order to generate $4.5 to $7.0 billion in additional U.S. exports. By our own estimates, DISC-induced exports range between $1.5 and $7.0 billion, with the moderate price responsiveness scenario suggesting DISC-induced exports of $5.3 billion.

An obvious question is the magnitude of additional tax revenues (benefits) due to these induced exports. In this simplified partial feedback example, net costs of DISC are computed by offsetting against the Treasury revenue loss estimate the following revenue feedbacks associated with DISC-induced exports:

- Additional corporate tax liabilities;
- Additional personal tax liabilities; and
- Additional payroll taxes.

Overall, when the feedback effects of induced exports are considered, Treasury recovers 29 to 176 percent of the initial DISC revenue losses from additional tax collections.[22]

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[22] Additional revenues from taxes on are supplier nonwage income are not considered.

1. Moderate Price Response Scenario

The following is a quantitative example of the DISC net cost calculation for the moderate price response scenario; that is, $5.3 billion of DISC-induced exports. The feedback calculations for the various price response scenarios are summarized in Table IV-1 and IV-2.

Treasury's $994 million DISC cost estimate includes lost revenues on all exports including those exports induced by DISC. As indicated earlier, the deferred taxes on DISC-induced exports should not be considered a cost of DISC, since in the absence of DISC exports would decline. Thus, the Treasury estimate should be reduced by $161 million (Table IV-2--revenue loss on induced exports) to obtain the true direct cost of DISC of $833 million for the $94.3 billion in exports that would occur in the absence of DISC.[23]

Assuming that the $5.3 billion induced exports represent a net increase in domestic output, the Treasury realizes additional revenues in several taxes on income. These indirect revenue effects are the result of increased profits that are subject to the corporate income tax; and increased wages and salaries that are subject to personal income and payroll taxes. The net effect of considering these sources of revenue is to offset more than the initial costs of DISC to the Treasury.

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[23] For purposes of this example, we have assume that these induced exports meet the incremental sales requirement; that is, 50 percent of DISC profits are deferred from taxation.

Table IV-1

NET COST OF DISC
BASED UPON PARTIAL FEEDBACK
OF REVENUES FROM INDUCED EXPORTS
ASSUMING A MARGINAL PROFIT RATE OF 6.4 PERCENT
DISC YEAR 1979
($ in millions)

	Low Response	Moderate Response	High Response
DISC Induced Exports	$1,547	$5,255	$6,996
Revenue Cost			
Treasury Estimate	$994	$ 994	$ 994
Less: Revenue Loss on Induced Exports	24	81	107
Revenue Loss	970	913	887
Net Cost of DISC			
Revenue Loss	$ 970	$ 913	$ 887
Less: Corporate Income Taxes	24	81	107
Individual Income Taxes 1,2	133	451	600
Payroll Taxes 3	124	420	559
Net Cost of DISC 4	$ 689	$ (39)	$ (379)
Revenues Recovered as a Percent of Revenue Loss	29%	104%	143%

1. Based on the distribution of 66 percent of the value of DISC-induced exports to labor in the form of wage and salary increases (see footnote 25).

2. Based on an average effective tax rate of 13 percent of labor income. Effective tax rate assumptions from Statistics of Income: 1978 Individual Income Tax Returns, published by U.S. Internal Revenue Service. Average wage rate assumptions from Employment and Earnings, published by U.S. Department of Labor. This tax rate assumes that half of all DISC-induced labor income is received by previously unemployed households and half is received by households already earning the average industry wage rate (on an annual basis).

3. Based on employer and employee contributions, each of 6.05 percent of all wages and salaries paid, assuming all workers' wages were below the $17,700 maximum during calendar year 1978.

4. Components may not sum to totals due to rounding.

Table IV-2

NET COST OF DISC
BASED UPON PARTIAL FEEDBACK
OF REVENUES FROM INDUCED EXPORTS
ASSUMING A MARGINAL PROFIT RATE OF 12.8 PERCENT
DISC YEAR 1979
($ in millions)

	Low Response	Moderate Response	High Response
DISC Induced Exports	$1,547	$5,255	$6,996
Revenue Cost			
Treasury Estimate	$ 994	$ 994	$ 994
Less: Revenue Loss on Induced Exports	48	161	215
Revenue Loss	946	833	779
Net Cost of DISC			
Revenue Loss	$ 946	$ 833	$ 779
Less: Corporate Income Taxes	48	161	215
Individual Income Taxes 1,2	133	451	600
Payroll Taxes 3	124	420	559
Net Cost of DISC 4	$ 641	$ (199)	$ (595)
Revenues Recovered as a Percent of Revenue Loss	32%	124%	176%

1. Based on the distribution of 66 percent of the value of DISC-induced exports to labor in the form of wage and salary increases (see footnote 25).

2. Based on an average effective tax rate of 13 percent of labor income. Effective tax rate assumptions from Statistics of Income: 1978 Individual Income Tax Returns, published by U.S. Internal Revenue Service. Average wage rate assumptions from Employment and Earnings, published by U.S. Department of Labor. This tax rate assumes that half of all DISC-induced labor income is received by previously unemployed households and half is received by households already earning the average industry wage rate (on an annual basis).

3. Based on employer and employee contributions, each of 6.05 percent of all wages and salaries paid, assuming all workers' wages were below the $17,700 maximum during calendar year 1978.

4. Components may not sum to totals due to rounding.

The increase in exports increases profits, some of which will be subject to the corporate income tax. For example, according to the 1979 DISC Annual report, the average profit margin on DISC sales is 6.4 percent. However, given that costs consist of fixed and variable components, the profit margin on the last dollar of sales should be greater than 6.4 percent. In our analysis, we used both the average profit margin (Table IV-1) and twice the average or 12.8 percent (Table IV-2). The following discussion is based on a 12.8 percent rate of profit. Thus, the corporate profits on $5.3 billion of induced exports would be about $673 million. Assuming that 50 percent of these profits are deferred through a DISC (all of the increase is assumed to pass the incremental test), then $336 million is taxed at the corporate income tax rate of 48 percent,[24] yielding $161 million in additional corporate profit tax revenues.

The $5.3 billion induced exports will increase wages and salaries and the associated personal income and payroll taxes.

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[24] The rate in effect for DISC year 1979 (calendar year 1978 income).

Assuming that 66 percent of the increase in sales translates into wages and salaries,[25] then $3.5 billion in income may be subject to taxation. If the marginal income tax rate is 13 percent (this assumes that one half of the additional income goes to households with no previously employed workers, a conservative assumption), then the additional wages and salaries will generate additional personal income tax revenues of $451 million. Payroll tax revenues will also increase. Assuming that the $3.5 billion is subject to the rate on employers and employees, 12.1 percent, then payroll tax revenues will increase by $420 million.

The increased exports will also leave suppliers with additional income through payments to suppliers for increased intermediate materials. These increased payments to suppliers will obviously have some feedbacks to the Treasury, though they are difficult to quantify and are not included here. Ultimately, however, all receipts are a return to labor, a return to capital, or a rent, and are subject to Federal tax.

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[25] Based on an average of (1) the proportion (for calendar year 1978) of domestic income for non-financial corporate business represented by wage and salary income of employees and (2) the proportion (for calendar year 1978) of net domestic product for non-financial corporate business represented by wage and salary income of employees. Domestic income differs from net domestic product in that the former includes "indirect business taxes and nontax liabilities plus business transfer payments less subsidies." We averaged the labor income proportion for the two measures because the increment to national product resulting from the DISC-induced exports would probably cause some marginal (but undetermined) increase in indirect business taxes. (Source: Survey of Current Business: Special Supplement, July 1981, U.S. Department of Commerce.)

To summarize, the $833 million "true" initial revenue cost of DISC will be more than offset by the following revenues collected from taxes on induced exports:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$ 161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

As a result of these offsets, for every dollar spent on DISC, the Treasury recovers through other taxes $1.24.[26]

2. Other Feedbacks

This simple feedback analysis considers only the major initial feedbacks on the Treasury and does not consider potential feedbacks from subsequent rounds of economic activity. Beyond the tax revenues from induced incomes to suppliers, state and local governments may also realize revenue benefits from DISC. Also, to the extent that unemployed or underemployed resources are devoted to the production of DISC-induced exports (the assumption of the analysis), Federal as well as state and local governments will realize reductions in transfer payments such as welfare and unemployment compensation.

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[26] This analysis requires the following two assumptions: exports represent a net increase in U.S. output and in the U.S. balance of trade. These and other assumptions are discussed in Section V.

When subsequent rounds of economic activity are considered, the Federal government will realize additional benefits from the DISC-induced exports. For example, a study to assess the cost effectiveness of an Eximbank subsidy program found that when the "ripple effects" on the economy over the life of the project are considered, the output effects may be more than double the expenditure on the project.[27]

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[27] See Wharton, EFA, Inc., "Budd Company and Westinghouse Electric Corporation Buenos Aires Subway Car Contract: Net Impact on the Government of Export-Import Bank Financing," 1981.

V. SOME ECONOMIC IMPACTS OF DISC IN A GENERAL EQUILIBRIUM FRAMEWORK

The major criticism of partial feedback analysis is that only the major, direct effects of a policy are considered. By neglecting other effects, particularly those that operate indirectly, the results of partial feedback analysis may be biased. Effects that are assumed to be unimportant may, on further analysis, operate to offset or augment the desired results of a program.

The partial feedback analysis described in the preceeding section requires several assumptions to quantify the effects of DISC on Treasury revenues. Two critical assumptions will be examined in this section. These assumptions are:

- The induced exports represent a net gain in the U.S. balance of trade, and
- The induced exports are a net increase in output for the U.S. economy.

In the short run, both these assumptions are plausible, though over time some offseting adjustments are likely to occur. Certainly today the U.S. economy is characterized by excess capacity and considerable unemployment. Thus, induced exports will likely add to, rather than be at the expense of, production for the domestic economy. Balance of trade adjustments depend critically on how increases in U.S. exports will affect exchange rates. In the short run, changes in the value of the U.S. dollar may be small. However, over time some appreciation in the value of the dollar can be expected which will lead to both an erosion of U.S. exports and an increase in U.S. imports.

In this section, we discuss the implications of these assumptions on domestic markets and international trade. Specifically, the effects of alternatives to these assumptions are considered by reviewing the potential impacts on overall economic efficiency and the responsiveness of foreign markets to the export incentives.

A. The Effects of DISC on the Balance of Payments

In Section IV, it was shown that DISC operates to increase net revenues from export activities. Essentially, there are two mechanisms for this increase. First, by decreasing the after tax cost of capital used in the production of exports, DISC increases the attractiveness of investing in export activities as compared to production for domestic use. Firms maximize profits by increasing their use of capital for export production. Second, the reduction in cost permits charging a lower price for exported products. If the demand for these products is elastic, total revenues will increase.

A net increase in revenues from exports, all other things equal, improves the balance of payments. This subsection presents several alternative views regarding the secondary effects of increased export revenues on the exchange rate and on the terms of trade.[28] This question is addressed to determine whether DISC creates effects in the foreign exchange markets which tend to offset the expansionary effects of DISC on output and employment.

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[28] The terms of trade of country A is the number of units that it can import from country B in exchange for one unit of its exports.

1. Initial Effects of the Increase in Export Revenues

The initial effect of an increase in revenues from export activities is to improve the balance of payments and decrease the terms of trade. A decrease in the price of exported goods, all other things being equal, requires the United States to sell a larger quantity of exports to earn the same amount of foreign exchange. The terms of trade deteriorate because the price of U.S. export goods declines while the price of import goods, initially, is constant. The balance of payments improves, however, because substantially more export goods can be sold at this reduced price. The increase in the quantity of exports more than offsets the reduction in price because the foreign sector has an elastic demand for imports.

Foreign consumers cannot purchase U.S. commodities directly. Because U.S. commodities are priced in dollars while foreign consumers hold other currencies, foreign consumers must first purchase dollars in the foreign exchange market. If the exchange rate is freely-floating, the value of the dollar may change. To the extent that the dollar value of exports rises, the demand for dollars in the foreign exchange market will increase and its price, relative to other currencies, will increase. An appreciation of the dollar will affect all commodities that the U.S. purchases or sells internationally. Imports will become relatively less expensive to U.S. consumers and exports relatively more expensive to foreign consumers, resulting in an increase in imports and a decrease in exports. These exchange rate effects may partially offset the initial expansion of exports that was attributed to DISC.

The simple result of a reduction in the price of exports leading to an appreciation of the dollar is not so straightforward in practice, however. A variety of factors affect the exchange rate including current and expected rates of inflation, interest rates, barriers to trade, and foreign exchange controls. There exists considerable controversy regarding the influence of speculation on the exchange rate, including the possibility that speculation causes the exchange rate to move farther away from an equilibrium value.[29] There are also indications that governments are actively intervening in the foreign exchange markets in order to fix the price of their currencies relative to other currencies. For example, the Japanese government may seek to keep the yen undervalued relative to the dollar.[30] If it is true that exchange rates fluctuate under a so-called "dirty floating" system, then any forecast based upon a simple theoretical model--that an increase in export revenues will cause an appreciation of the dollar and a subsequent reduction in exports and increase in imports--will not be accurate.

Because exchange rates depend on a multitude of factors, it is impossible to estimate accurately the impact of DISC on the exchange rate of the dollar. While the initial effect of a DISC-induced increase in export revenues is to exert upward pressure on the dollar, this pressure may not be substantial due to the importance of other factors. In addition, the effectiveness of DISC in increasing exports has other economic consequences which separately affect the trade balance and the exchange rate. It is to these effects that we now turn.

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29. Baumol, W.J., "Speculation, Profitability and Stability," Review of Economics and Statistics, August 1957, pp. 253-271.

30. "A Yen Too Cheap," The Economist, March 20-26, 1982.

2. Long-term Effects of the Increase in Export Revenues

In a general equilibrium analysis, the effects of DISC on the U.S. economy and the foreign economy must be considered to determine whether DISC causes upward pressure on the exchange rate. In turn, these effects depend on characteristics of the domestic and foreign economies and on the method of financing the tax incentive offered by DISC. The principal methods of financing DISC are as follows:

- A reduction in the government budget surplus;
- An increase in general income taxes;
- A reduction in government purchase of goods and services; and
- An increase in government borrowing.

Each of these methods of financing DISC has effects on the foreign and domestic economies independent of the increase in U.S. exports. The net effect of DISC on exchange rates depends on the interaction of the export effects and the financing effects.

Government Budget Surplus. If the DISC tax adjustment is financed through a reduction in a government budget surplus, there is no financing effect on the domestic economy. DISC has a depressing effect on foreign incomes, however, as U.S. exports displace foreign production (either in the country that purchases U.S. goods or in the country that otherwise would have exported the goods to the receiving nation). But U.S. exports depend partially on the incomes of receiving nations and, to the extent that these incomes decline due to reduced exports, the upward pressure on the exchange rate is reduced.

General Income Taxes. On the other hand, if an income tax is used to offset the DISC program, U.S. imports may decline as reduced disposable income lowers demand for imports. This import reduction may offset the export reduction that results from declining foreign incomes.

Government Purchases of Goods and Services. Similarly, a reduction in government expenditures, ceteris paribus, reduces domestic income and, consequently, imports. This effect is offset to the extent that increased resource use by the private sector increases national income. Generalizing, then, financing through an income tax or through a reduction in government purchases, exerts upward pressure on the exchange rate if the increased export revenues (resulting from a decrease in the price of exports) plus the decline in U.S. imports (due to a decline in disposable income) exceeds the decline in foreign imports caused by a decline in foreign disposable income.

Government Borrowing. Alternatively, the DISC program may be financed by government borrowing. If borrowing displaces private sector borrowing, the macroeconomic result will be analagous to the use of an income tax, except for differing distributional effects. On the other hand, the government may be borrowing capital that the private sector is reluctant to invest due to perceived adverse business conditions. Thus, the government will use funds that otherwise would not be employed. This case is analogous to a reduction in the government surplus.

Summary of Long-term Effects. The effect of DISC on appreciation or depreciation of the dollar depends, therefore, on the elasticity of the demand for U.S. exports, the method of financing DISC, on the relationship between U.S. income and U.S. imports and between foreign income and foreign exports, and on the effect of changes in government expenditures on the U.S. economy. In addition, a number of factors affect the speed at which the exchange rate adjusts; these factors may render the outcome even less determinate.

If the increase in U.S. exports is financed by the foreign nations through U.S. bank loans, the initial effects (from the U.S. point of view) are an export of goods on the current account and a outflow of funds on the capital account. These effects, in terms of the overall balance of payments, cancel and have no effect on the exchange rate. As the loans are repaid, however, the repayment improves the balance of payments and puts upward pressure on the exchange rate. While alternative scenarios are possible, it is significant that under one likely scenario the employment and output effects of the increased exports are realized initially, while the exports induce a movement in the exchange rate only over time.

3. Summary

There is no doubt that in a system of freely floating exchange rates an increase in the value of exports, all other things being equal, will tend to cause the exchange rate of the exporting nation to appreciate. There exist, however, circumstances in which the exchange rate will depreciate. There also exist a large number of factors which must be held constant for this general result to hold. Changes in the money supply or the rate of interest by the central bank, for example, can offset a movement in exchange rates resulting from increased exports. There is considerable question, given the behavior of foreign currencies, whether exchange rates are freely-floating. Because of the large number of diverse factors affecting the exchange rate, the impact of DISC in this area must be regarded as uncertain.

B. The Effects of DISC on the Net Output of the U.S. Economy

The partial feedback analysis in Section IV assumed that DISC-induced exports resulted in a net increase in output of the U.S. economy. DISC is assumed to result in the use of resources that would otherwise be unemployed. If instead DISC shifts resources from one sector to another, the increase in output in some sectors must be offset by the loss of output in other sectors. In this case, the total effect of DISC on output and employment will be indeterminate.

DISC may affect total output in one of two related ways. First, DISC may change the total amount of capital employed in the economy. Second, DISC may change the economic efficiency of society. We will consider both of these effects in examining our assumption of increased output.

As discussed in Section II, DISC reduces the cost of capital employed in export activities. Investment projects evaluated against this reduced cost of capital appear more favorable and are more likely to be undertaken. Capital will be deployed to these investment projects. To establish the validity of the assumption of a net increase in output, the source of this capital must be identified.

If we assume the converse--that no net increase in employed capital results--we must implicitly assume that the supply of capital to these industries is infinitely inelastic. This assumption is unrealistic. First, with the development of the Eurocurrency market, the cost of capital is largely determined in international markets. The volume of credit handled in these markets is extremely large. Given the size of these markets relative to the financing requirements of DISC-induced exports, it is likely that these additional requirements can be met without affecting the cost of capital. Second, even if the cost of capital rises, the returns to savers will also rise. The increased returns available will affect the consumption/saving behavior of individuals and result in increased savings and increased investment funds.

For these reasons, we are persuaded that a net increase in capital investment occurs as a result of DISC. Taken from the point of view of the U.S. economy, the allocation of capital is not a zero-sum game in which increased capital formation in one sector requires decreased capital formation in another sector. New capital can be obtained either from foreign sources or from increased saving--either domestic or foreign.

The availability of labor is obvious. Given the current high rates of unemployment, we reject any assumption that increased demand for labor in one sector cannot be met without diverting labor from other sectors.

An additional possible source of increased total output due to DISC is an increase in economic efficiency. An improvement in economic efficiency means that the economy can produce a greater level of output with a fixed set of resources. Thus, even if the assumption of increased resources is not met, output may be increased if current resources are used more efficiently.

In general, economic theory holds that artificial incentives will reduce the efficiency with which economic output is generated. If we consider a program offering tax incentives to a segment of the economy to encourage specific activities, a loss of efficiency results from the increased rate of return available in those sectors. The existence of higher rates of return in these sectors causes the diversion of productive inputs from other sectors until after-tax rates of return are equalized across all sectors. Under these circumstances, society has moved away from more optimal distribution of production capacity toward a less optimal distribution.

As a practical matter, it is difficult to determine the efficiency effects of any specific tax incentive because we live in a world which does not treat all productive capacity equally. In the United States alone, the existence of our complicated tax structure causes a loss in efficiency from the "optimal" point through a system of credits, exemptions, etc. Further, biases in the worldwide economy are introduced as a result of the differences in tax treatment across national boundaries.

Under the current situation, it is reasonable to suppose that certain tax incentives may increase economic efficiency by introducing changes in the tax law which make it more neutral in its treatment of factors of production. There are certain conditions under which this might occur. These conditions are categorized under two broad headings below. Under the first heading, we discuss conditions under which tax changes might increase efficiency within one nation. In the second section we discuss conditions under which tax changes might increase worldwide efficiency.

1. National

Within the U.S. four major sources of non-neutrality in the tax treatment of capital have been cited which may introduce distortions in the distribution of capital across sectors and/or in the distribution of economic assets among capital and other productive inputs (both within and across sectors). These are:

- Depreciation Schedules. Many analysts believed that the CLADR depreciation schedules in force prior to the passage of ERTA (Economic Recovery Tax Act of 1981) introduced distortions into the treatment of capital versus non-capital inputs to production. CLADR, for instance, was often cited as a major retardant to the adoption of energy conservation by manufacturing firms because fuel expenditures could be expensed (written-off in the year incurred) while most investments in energy conservation had to be depreciated over their lifetime. The effect of ACRS (Accelerated Cost Recovery System) depreciation schedules is to promote greater capital investment than under CLADR. Whether, however, ACRS eliminates or merely reduces any bias against capital investment inherent in the tax code as a whole is problematical.

- Double-taxation of Dividends. Returns to capital paid to individuals through corporations are subject to double taxation--first at the corporate level and then at the individual level. This reduces the effective rate of return on capital investments, which, in turn, increases the return required by individuals for such investments. The result is a bias against corporate capital investments relative to other types of investments.[31]

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[31] Boskin estimates the welfare losses associated with U.S. tax treatment of returns to capital at $50 billion annually. See M. Boskin, "Taxation, Saving, and the Rate of Interest", Journal of Political Economy (April 1978, Pt. 2).

- Treatment of Public vs. Private Capital. Public capital (e.g., schools, hospitals, roads) is exempt from tax in the U.S. while private capital is not exempt. Horst[32] and others have argued that this introduces a bias against investment in private capital. In Horst's view, any proposal which reduces the marginal rate of taxation on any portion of private capital investments would promote a more efficient allocation of capital in the U.S.

The effect of any of these three aspects of the tax code on the treatment of capital in light of other provisions of the tax code is not clear. If, on balance, the tax code is biased against private capital (either in relation to other productive inputs or in relation to public capital), special tax incentives which reduce or eliminate these biases would increase economic efficiency.

2. International

There are two general conditions under which the existence of an export-oriented tax incentive (such as DISC) in one nation might increase worldwide economic efficiency.

- Reduction of Trade Barriers. In many cases specific national markets are partially insulated from competition through the application of tariffs or through structural factors. If price reductions which result from export incentives are large enough, they may serve to overcome such barriers and open new markets.

- Reduction of U.S. Disadvantage. The worldwide tax structure may be nonneutral in its treatment of investments in the U.S. versus competing locations. For

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[32] Thomas Horst, "An Economic Analysis of the Foreign International Sales Corporation Proposal," September 1981 (unpublished).

> instance, nearly all other nations offer export incentives which are frequently more generous than those contained in DISC. Under these conditions, DISC may help redress an existing imbalance and promote increased economic efficiency.

3. Result of Increased Economic Efficiency

The result of an increase in economic efficiency would be an increase in the level of output and income. If such an efficiency increase could be brought about through an export-oriented tax incentive, such an incentive would also increase the level of exports and imports. Exports would increase from those sectors which possessed a comparative advantage in the world market and imports would be increased for those sectors where American producers were at a comparative disadvantage in world markets. The welfare of U.S. producers and consumers would increase.

VI. THE EFFECTS OF ELIMINATING DISC

This section reviews the costs and benefits of DISC and summarizes the revenue implications of repealing the DISC provisions. The effects of DISC are considered before and after implementation of the Accelerated Cost Recovery System (ACRS) established under the Economic Recovery Tax Act of 1981. Overall, for the moderate price response case, every dollar spent on DISC increases Federal tax revenues by $1.24. Thus, repeal of DISC would reduce Treasury revenues rather than increase them.

A. Cost/Benefit Assessment

Section III established that DISC would stimulate additional exports valued between $1.5 and $7.0 billion in DISC year 1979. According to Treasury, these additional exports are realized at an initial cost in revenues foregone of $994 million.[33] However, as suggested in Section IV, the DISC induced exports generate additional Federal tax revenues. For example, $5.3 billion in DISC induced exports (the moderate price response case) will generate the following additional Federal tax revenues:

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[33] This figure includes the foregone taxes on DISC deferred income from the induced exports. A correct revenues foregone calculation would net out tax losses on the induced component. For example, the true cost in the moderate case would be $833 million ($994 million less $161 million; that is, the revenue loss associated with the $94.3 billion of DISC sales that would have existed in the absence of DISC).

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$ 161
Personal Income Taxes	451
Payroll Taxes	420
Total	$1,032

As a result of the feedbacks, DISC generates more in revenues than its initial costs to Taxpayers. For example, in the moderate case, the initial revenue loss of $833 million[34] is more than offset by the $1,032 million generated from the three major taxes on a portion of income from DISC induced exports. In this case, repeal of DISC would not only reduce exports by $5.3 billion but would also cost the Treasury $199 million in net tax collections.[35]

There are several reasons why these changes in net tax collections may be considered conservative. First, the net revenue loss from eliminating DISC reflects only a few of the more obvious feedbacks. For example, revenues associated with DISC-induced income to suppliers were not included in the calculation. Second, only revenue impacts were considered in the partial feedback analysis. If DISC were repealed, the implied reductions in output could lead to increases in Federal outlays for various welfare programs as well as increases in unemployment benefits.

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[34] After adjusting for revenue losses on DISC induced exports. See previous footnote.

[35] These revenue loss figures depend upon the assumption that resources used in the production of DISC-induced exports were previously unemployed and that the export increase represents a net increase in the U.S. balance of trade.

Finally, the calculations only consider the initial feedbacks caused by the DISC induced exports. However, in subsequent rounds the feedbacks may be multiplied and result in additional revenue losses from the repeal of DISC. These feedbacks are difficult to quantify. However, a recent study of subsidies implicit in Federal Eximbank loans suggests that the ripple effects through the economy would more than double the initial output effect of DISC.[36] Thus, this additional output would lead to additional tax collections.

B. Repeal of DISC with ACRS

Treasury's most recent revenue loss estimates for DISC do not include the effects of ACRS. In general, ACRS reduces the effective tax rate on the corporate sector and there is no reason to expect this effect to be disproportional between production for domestic consumption and production for export. Since ACRS will reduce the amount of income that can be deferred from taxation through DISC, it will reduce the revenue losses associated with the DISC deferral. While total exports may not change under ACRS, estimates of DISC-induced exports will decline because of the smaller DISC price effect with the presence of ACRS.

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36. It was found that the ratio of change in the Gross National Product to the expenditure subsidized by the Eximbank was 2.2 over the life of the project. See Wharton, EFA, Inc., "Budd Company and Westinghouse Electric Corporation Buenos Aires Subway Car Contract: Net Impact on the Government of Export-Import Bank Financing," 1981.

The U.S. Treasury suggests that with ACRS, DISC costs and induced exports would decline proportionally. Treasury estimates that ACRS would reduce both DISC costs and induced exports by 27 percent.[37]

Using the Treasury figures on the impacts of ACRS, the previously stated conclusions regarding the cost/benefit implication of repealing DISC would not change. For example, after ACRS the Treasury revenue loss estimate for DISC would decline to $608 million (73 percent of $833 million) and DISC-induced exports in the moderate price responsive scenario would decline to $3.9 billion. This new level of DISC-induced exports would result in the following tax collections:

	Revenue Feedbacks ($ in millions)
Corporate Income Taxes	$118
Personal Income Taxes	329
Payroll Taxes	307
Total	$754

Post-ACRS, repeal of DISC would reduce revenue collections by $146 million in DISC year 1979 rather than the previously stated amount of $199 million revenue loss before considering the effects of ACRS. While ACRS erodes some of the net revenue benefits of DISC, after ACRS DISC still provides a net benefit; that is, for every dollar of tax expenditure for DISC, Treasury collects $1.24 in addition taxes on profits, wages, and salaries.

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[37] "Export Tax Incentives," Memorandum for Secretary Regan from Norman Ture, Under Secretary for Tax and Economic Affairs, October 28, 1981.

Once again, these figures are conservative in that they do not reflect outlay impacts as well as multiple feedbacks from the ripple effect on the economy.

C. Conclusions

The quantitive assessment of the costs and benefits of DISC presented in this study suggest that exports would decrease significantly with the repeal of DISC, while Treasury receipts would not rise. This finding remains true even when the effects of ACRS are considered. These findings should be considered suggestive rather than predictive since they are based upon a partial feedback analysis. This partial feedback analysis required simplifying assumptions for purposes of quantification and did not quantify numerous other feedbacks that may augment or diminish the final result.

Senator **Danforth**. Gentlemen, thank you very much.

Do I take it from your testimony that you have found DISC to be a valuable tool of American business in attempting to do business in world markets?

Mr. **Joranko**. Yes, Senator. I believe that is true. The Price Waterhouse study said that in fact for every $1 of revenue spent, $1.24 was returned because of the DISC.

Also, the Treasury report said that DISC added $7 to $11 billion a year to additional export business, which meant 25,000 jobs per billion.

Senator **Danforth**. And as a substitute for DISC, how do you view this program? Is it going to be as effective, or not as effective? How will it compare, not from the GATT or the legality standpoint but from the standpoint of encouraging business?

Mr. **White**. We are of the view that the FSC will basically be an adequate replacement for the DISC and will provide roughly the same incentive for export activity as we find in the DISC.

The only area of concern that the CMA has found in respect to this legislation is that the foreign substance requirements seem to be more than is necessary to meet the requirements of the GATT rule.

Mr. **Werling**. On behalf of the U.S. chamber, we also concur that the FSC regulations are an adequate substitute. Our biggest concern in implementing the regulations is the fact that very few small businesses in this country have the foreign presence capability at the present time to be able to accommodate this in the near term. And when it comes to small- and medium-size companies, that is really where the growth opportunities for international trade exists in this country, we need to give those companies, the small businesses in this country, a transitional period so they can develop capabilities necessary to accommodate the FSC regulations.

Senator **Danforth**. How would they handle that? What would they do?

Mr. **Werling**. I think there are several ways they can handle it. With the enactment of the Export Trading Company Act, I think we are going to see many more service bureaus set up overseas that will accommodate many of the administrative functions related to this. We will probably also see joint ventures established by very small businesses such as ours who presently have a DISC, and that will make it economical for them. But it will take a period of time to adopt to these regulations.

Senator **Danforth**. With these small companies joining together in these foreign sales corporations?

Mr. **Werling**. Yes, or through some kind of a joint venture with other groups, such as an export trading company or an export management company.

Senator **Danforth**. In other words, you see this meshing well with the export trading companies?

Mr. **Werling**. Very definitely. On the other hand, if they didn't join that type of an association, economically it would be a significant drain to small business because most of them cannot afford individually to establish these offshore capabilities.

Senator **Danforth**. How is the Export Trading Company Act working out, in your view?

Mr. **Werling**. Well, I think the most important element of the Export Trading Company Act was, it really woke America up concerning the importance of getting all of our economy—small- and medium-size companies as well as large-size companies—involved with international trade.

We are living in a world economy. Many small businesses didn't realize that prior to that date. I don't think the technical elements of the bill, such as the antitrust legislation or allowing commercial banks to take an equity interest, I don't think those are the most important parts of the bill; I think that we could have performed most export functions without enactment of the Export Trading Company Act, but it really brought to light, to all America, the importance of everyone getting involved in world trade.

Senator **Danforth**. And is American business, in your view, aware of the Export Trading Company Act?

Mr. **Werling**. I think very definitely. I have been working with the Department of Commerce and the district export council in southern Ohio as well as in Washington to publicize this, and small business has a tremendous interest—a greater awareness today than ever before—of the importance of getting involved in world trade.

Senator **Danforth**. And the same would be so with respect to the foreign sales corporations?

Mr. **Werling**. I think very definitely.

Senator **Danforth**. Is there an effort on the part of the chamber or small business in general to take a look at it and find out what it is all about?

Mr. **Werling**. That is one of the reasons that I'm here today, because small business is vitally interested that it has an opportunity to mesh this legislation with the export trading company opportunities.

Senator **Danforth**. And your view is that, if that is done, generally this concept would be as successful as DISC?

Mr. **Werling**. I think it will be more successful because of the enactment of the Export Trading Company Act, and the fact that more small businesses want to move into world trade. Yes. It will be more successful than the present DISC, because a lot of small businesses haven't been involved in export trade prior to this time.

Senator **Danforth**. Do any of the rest of you have any comments?

Mr. **Fayhee**. Senator, my name is Mike Fayhee, and we are here on behalf of the NCFC.

There is one group of small businesses that we think are effectively precluded from taking advantage of this legislation, and that would be the small farmers.

As the bill now stands, farmers would be entitled to set up a foreign sales corporation, but we think as a practical matter none are of a sufficient size to be able to do so. And the only effective way that they will be able to take advantage of this legislation, we believe, will be through their cooperatives, which are gathering the grain and putting it in a position to export.

Mechanically the legislation will not permit cooperatives to effectively utilize this legislation, and we are seeking amendments so that the tax incentives that are being provided to exporters can be utilized by the co-ops and by the farmers.

Senator DANFORTH. All right.

What else should we be doing?—that is, on the export front. We've got this going, and I think we will enact this next year. What else should we be doing?

Mr. WERLING. As far as small- and medium-size companies are concerned—and this is the area that I'm vitally concerned with because I think it is the greatest growth area in this country. The multinationals are already involved in world trade, but I think the single most important change that Congress could enact next year would be consolidation of the many facets of the Federal Government that are involved in promoting international trade.

Senator DANFORTH. I think I asked the wrong question. [Laughter.]

Mr. WERLING. Because I'm speaking as——

Senator DANFORTH. Anything else? [Laughter.]

Mr. WERLING. No; but since you asked the question, I have been involved as a small businessman, really, trying to work with all the different elements of the government, and it is a very fragmented process. It's a maze for small business to try to work through.

Senator DANFORTH. All right.

It is not going to be any less fragmented if we have a Department of Trade. But I learned in law school never to ask a question unless you know what the answer is. It's been a long week. [Laughter.]

Gentlemen, thank you very much.

Does anybody else have anything they would like to add for the good of the cause? I think we have written statements from each one of you, and they will be in the record and will be read with great care, and we look forward to working with you as we proceed with this legislation.

Thank you very much.

[Whereupon, at 9:53 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF
THE AMERICAN PAPER INSTITUTE
TO THE SENATE FINANCE COMMITTEE, NOVEMBER 18, 1983

SUMMARY

Our industry is aware of the issues raised by our trading partners under the General Agreement on Tariffs and Trade (GATT) regarding the existing DISC tax-based export incentive. In order to help resolve these issues, our industry supports efforts to design a viable DISC substitute.

The U.S. paper industry has a large number of DISCs, and has an excellent record of export growth which can be related to DISC. A significant portion of the industry's participation in foreign markets is through exports. Without a suitable tax-based replacement, both large and small paper companies would have greater difficulty competing in world markets at a time when our country needs to increase its exports.

The American Paper Institute strongly supports the proposed tax-based export incentive, but recommends reasonable clarification of certain key provisions in S. 1804 to facilitate the use of that incentive by exporters.

We are particularly concerned with the administrative problems and costs faced by smaller companies. We recommend a significant increase over the present $2,500,000 amount allowable as foreign trading gross receipts of a small FSC.

We believe that S. 1804 is GATT compatible, but feel that this feature would be strengthened even further by adoption of our recommendation that the FSC not be subject to U.S. tax on a portion of its income. Shifting taxation to the shareholder level would provide the FSC with a strong foreign presence.

STATEMENT OF
THE AMERICAN PAPER INSTITUTE
TO THE SENATE FINANCE COMMITTEE, NOVEMBER 18, 1983

My name is Ira Stone. I am Vice President of Stone Container Corporation and President of its International Division. With me is Alvin Yanofsky, Senior Tax Attorney, International, International Paper Company. We are appearing on behalf of the American Paper Institute, which represents over 165 companies which produce over 90% of the pulp and paper manufactured in this country.

Our industry is aware of the concerns raised by our trading partners under the General Agreement on Tariffs and Trade (GATT) regarding the existing DISC tax based export incentive. In order to help resolve these issues, our industry supports efforts to design a viable DISC substitute.

The export potential of U.S. paper companies would suffer without an acceptable DISC replacement. Several studies have indicated that the European Community, Japan and other foreign countries currently offer significantly greater incentives to their exporters than have ever been available to U.S. exporters under the DISC provisions. Without a suitable tax-based replacement, both large and small paper companies would have greater difficulty competing in world markets at a time when our country needs to increase its exports.

The U.S. paper industry has an excellent record of export growth which can be related to use of DISCs by both large and small companies. A significant portion of the industry's participation in foreign markets is through exports. Between 1972 and 1981, U.S. exports of pulp, paper, paperboard and converted products increased from $1.1 billion to $4.9 billion. The worldwide recession reduced exports in 1982 to $4.3 billion.

The American Paper Institute strongly supports the proposed tax-based export incentive, but recommends reasonable clarification of certain key provisions in S. 1804 to facilitate the use of that incentive by exporters.

We recognize that considerable progress has been made in clarifying the foreign presence requirements since this legislation was first introduced on August 4. It is essential, however, that all of the agreed upon clarifications be reaffirmed in the form of Committee Report language so that subsequent regulations will properly reflect Congressional intent. In a separate Appendix to this statement we have analyzed several other issues as well, and recommended specific approaches.

In addition to the items outlined in this attachment, we want to express particular concern with the administrative problems and costs faced by smaller companies. Two suggestions would be to significantly increase the present $2,500,000 amount allowable as foreign trading gross receipts of a small FSC and to provide an alternative measure of a small FSC on the basis of taxable income. In any case, however, attention should be devoted to easing the compliance and cost burden on small companies, in order to permit these companies to realize their full export growth potential.

In conclusion, I would like to offer one final comment on the broad issue of GATT compatibility as requested in the Committee announcement of this hearing.

We believe that S. 1804 is GATT compatible, but feel that this feature would be strengthened even further by adoption of our recommendation that the FSC not be subject to U.S. tax on a portion of its income. Eliminating this requirement and shifting taxation to the shareholder level would provide the FSC with a strong foreign presence.

We thank you very much for this opportunity to present our views. Our detailed recommendations are contained in the attached Appendix.

C. Commission FSC

Clarification is required as to how an FSC will operate in the case of a commission FSC.

2. PROPOSED AMENDMENTS

A. U.S. Taxation of FSC Income

The FSC is not subject to U.S. tax on exempt foreign trade income. The FSC is, however, subject to tax on foreign trade income other than exempt foreign trade income and also on dividends, interest, royalties and other investment income. The shareholders of the FSC are allowed a 100% dividend exclusion on exempt and non-exempt foreign trading income, but not on investment or other income.

A better approach would be to treat the FSC as not subject to any U.S. taxation. As is the case with DISC, taxation would only be at the shareholder level. The dividend exclusion could be adjusted to arrive at a "revenue neutral" position (as, for instance, the proposal contained in Boren, S. 28). This would allow an offset for any parent company losses, which is currently available as an offset to distributions from a DISC. Although FSC dividends could be deemed to its shareholders, we recommend that this not be accomplished through the "Subpart F" provisions of the Internal Revenue Code. To avoid the complexities of "Subpart F" we suggest that the FSC deemed distribution requirements be established in a separate new Section (such as was established for the DISC; e.g., Sec., 995).

In this case, the shareholders would file an information return on behalf of the FSC but the FSC would be relieved from all other U.S. tax return and tax payment requirements. The principal shareholder of the FSC could be required to maintain complete books and records of the FSC at a location in the United States.

One of the objectives of the DISC replacement legislation is to make the replacement (FSC) GATT compatible. This is accomplished by giving the FSC a foreign presence. We feel that requiring the FSC to be subject to U.S. tax on a portion of its income weakens the FSC's foreign presence position. On the other hand, if the taxation is shifted to the shareholder level, the foreign presence argument is strengthened.

B. Taxable Year Requirement

The bill includes a requirement that the FSC adopt the same taxable year as its largest shareholder. The present DISC rules do not include this requirement and we see no reason for the FSC to be under a more restrictive rule. We believe that allowing a FSC the same freedom of selecting a taxable year as other foreign corporations strengthens its foreign presence posture.

PROPOSED AMENDMENTS

2. A. (1) EXAMPLE - FSC WITH NO INVESTMENT INCOME

	Administration Bill (FSC Subject to U.S. Tax)	Alternative (FSC Not Subject to U.S. Tax)
Export Taxable Income	$1,000	$1,000
Allocable to FSC @23%	230	230
Exemption (17/23 x 230)	170	-
Net Subject to U.S. Tax	60	-
U.S. Tax @46%	28	-
Earnings and Profits	202	230
Dividend Deduction(100%)	202	(74%) 170
Taxable to Shareholders	-	60
U. S. Tax on Shareholders @46%	$ -	$ 28

2. A. (2) EXAMPLE - FSC WITH INVESTMENT INCOME

	Administration Bill (FSC Subject To U. S. Tax)
Export Taxable Income	$1,000
Allocable to FSC @23%	230
Other Non-Foreign Trading Income (Interest, Dividends, etc.)	100
Total FSC Taxable Income	330
Exemption (17/23 x 230)	170
Net Subject to U.S. Tax	160
U. S. Tax @46%	74
Earnings and Profits	256
Dividend Deduction (170 + 60 - 28)	202
Taxable to Shareholders	54
U. S. Tax on Shareholders @46%	$ 25

Statement of

The Associated General Contractors of America

Presented to the

Senate Finance Committee

December 10, 1983

On the Topic of

The Foreign Sales Corporation Act

SKILL RESPONSIBILITY INTEGRITY

AGC is:

- More than 32,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
- 112 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities;
- Over $100 billion of construction volume annually.

The Associated General Contractors of America (AGC) represents more than 32,000 firms including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3.4 million individuals. AGC members perform more than 80 percent of America's domestic contract construction and more than 50 percent of the contract construction by American firms abroad.

AGC is pleased to submit comments on the Foreign Sales Corporation Act of 1983 (S. 1804). International construction contractors can presently make only limited use of Domestic International Sales Corporations which would be replaced by Foreign Sales Corporations in the proposed legislation. The present limited use of Domestic International Sales Corporations is due to the very limited categories of foreign trade income eligible. This limited use of Domestic International Sales Corporations will be even further restricted by the Foreign Sales Corporation proposal's foreign presence and economic activity requirements. The provisions for interest charge Domestic International Sales Corporations (DISCs) and small Foreign Sales Corporations (FSCs) do not remedy the faults of the proposed legislation. As a result, AGC is opposed to S. 1804 in its present form.

DISC eligibility for income resulting from international construction activities is presently limited to engineering and architectural services. These two categories of services do not adequately cover the types of services performed by construction contractors. Contractor services also include project management, procurement, cost estimating, scheduling, construction planning, and construction mobilization services. In addition to these construction related services, which result in increased domestic employment, the economic value of the actual construction of the project is also not eligible for DISC treatment. AGC recommends that the FSC proposal be amended to include all construction and construction related services to correct the inadequate categories of income covered by present DISC rules.

The FSC foreign presence and economic activity eligibility tests will be difficult to meet for many smaller international construction contractors. Many contractors are not active in the international market on a permanent basis, and are operational overseas only for a single construction project with an absolute completion date. While single contracts may generate significant revenues the maintenance of a permanent office may not be a necessary or needed function.

The "small FSC" and "interest charge DISC" provisions of S. 1804 are not adequate to correct the defects of the proposed legislation. The $2.5 million limitation in foreign trading gross receipts significantly limits any benefits of the provision. The small FSC limited foreign presence test is less burdensome than the ordinary FSC requirement. The small FSC is not required to perform economic activities outside the United States but is required to maintain an office, a set of permanent books at that office, and have at least one non-resident director. AGC recommends that such offices be allowed to be maintained on a shared basis.

The interest charge DISC allows a business with less than

$10 million in qualified export receipts to continue to operate if a Treasury bill interest rate is paid on the taxes deferred. This is significantly less beneficial than the present DISC rules for qualifying firms. The value of a tax deferral is the time value of money, imposing a tax of 8.9 percent (November 16, 1983 Treasury bill rate) on the value of the DISC deferral essentially eliminates the benefits of the DISC election.

AGC believes that S. 1804 will not meet its stated intention of being a revenue neutral bill which preserves the benefits of DISC for present users in the construction industry. We suggest that the foreign presence test and economic activity tests be substantially relaxed. In addition, AGC urges that a more realistic coverage of income generated from construction and related construction services be made eligible for FSC coverage.

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Roderick A. DeArment, Esq.
Chief Counsel
Committee on Finance
Room SD-219, Dirksen Senate Office Building
Washington, D.C. 20510

November 18, 1983

Dear Mr. DeArment:

Enclosed for the written record are five copies of my testimony on behalf of the Coalition of Service Industries, Inc. regarding the Foreign Sales Corporation Act (S. 1804). This testimony was prepared for the hearings scheduled for today. I would urge the Committee to hold additional hearings on this legislation at the earliest possible date. At that time, the Service Industries Coalition would be most pleased to appear.

Thank you.

Sincerely,

Michael J. Cooper
Michael J. Cooper by EMS

Enclosures

Statement of
Michael J. Cooper
On the Treatment of Foreign Export Income
Before the Senate Finance Committee on November 18, 1983

I am Michael J. Cooper. I am appearing here today on behalf of the Coalition of Services Industries, Inc. (The "CSI").

The CSI consists of 30 major U.S. service corporations which represent a wide cross-section of the service industries of the United States, including brokerage, consulting, and telecommunications. A membership list is attached.

The CSI was formed in 1982 (1) to foster a public awareness and understanding of the enormous contribution that these industries make to U.S.-economic growth, job-creation, and balance of payments, (2) to identify and address public policy issues affecting the growth of service industries, and (3) to contribute to the formulation of a coherent national policy that permits service industries to compete with foreigners on an equal basis in the international services market.

Private sector service industries are labor-intensive. Services now account for fully 67% of total GNP. In the important area of domestic employment, over half of all private sector jobs are produced by serice industries, and if government workers are included, 70% of all jobs in the U.S. economy derive from the production and delivery of services. In 1982, activities of U.S. service industries abroad resulted in an estimated $135.7 billion in repatriated foreign revenues and generated roughly $3.4 billion in related merchandise trade transactions.

These same industries have made the United States the world's leading provider of services. The export of these services has produced a long-term, positive impact on U.S. balance of payments. Surpluses from the export of services have consistently reduced merchandise deficits in our balance of payments. Chart III.

The Congress of the United States recently recognized the enormous contribution that U.S. service industries can and are making to the economic well-being of the U.S. In the Export Trading Company Act of 1982, Congress defined export trade to include both the export of services and the export of goods.

The purpose of DISC and its replacement is to stimulate the export of products produced in the U.S., thereby (1) creating or maintaining jobs for Americans who produce or furnish those products, (2) reducing balance-of-payment deficits, and (3) offsetting export tax benefits granted to foreign competitors. We wholeheartedly support these admirable goals and the efforts of the Congress and the Administration to fashion an export incentive program that satisfies our treaty obligations and the demands of the international marketplace.

However, export services create or maintain jobs for the Americans who furnish those services, just like export products create or maintain jobs for Americans who manufacture those products.

The income realized from the sale of export services reduces balance-of-payments deficits, just like income realized from sales of export property.

Moreover, U.S. services industries are competing for a share of the international services market with foreign competition that receives foreign export tax benefits and other preferential treatment, just like foreign competitors of U.S. manufacturers.

Nonetheless, the U.S. service industries are not accorded equal treatment with other sectors of the U.S. economy by the Domestic International Sales Corporation (DISC) export incentive program.

Specifically, the DISC program is designed to defer a certain portion of the export income realized by a U.S. person from the sale or lease of export property (tangible personal property produced or manufactured in the U.S.) for ultimate consumption or use outside the U.S. As such, virtually all export sales of such property (with some exceptions) can qualify for DISC benefits if properly structured.

By contrast, nearly all export service income realized by U.S. persons is excluded from DISC benefits. Export services income includes income from the sale of services performed in the U.S. (1) that are consumed abroad, (2) that facilitate the consumption abroad of export property or services, (3) that create intangible property (such as advertising spots, or patents) sold or leased for consumption abroad, or (4) that are performed abroad by U.S. based-persons.

The only export service income that qualifies for DISC benefits are engineering and architectural services on construction projects, limited managerial services, and some services related and subsidiary to the sale of export property. Thus, export income realized from performing consulting services, educational services, financial services, food processing services, health services, insurance brokerage services, insurance services on foreign risks, management services, maintenance services that are not related or subsidiary, private postal services, stock brokerage services, telecommunications and data processing services, transportation services, travel services, to name a few, will ordinarily not be eligible for DISC benefits.

The Foreign Sales Corporation Act (FSC), the proposed replacement to DISC, would exclude virtually the same export services that are excluded from DISC benefits.

For the reasons stated above we respectfully recommend that your Committee modify the DISC and FSC provisions to extend the benefits provided to the export of services as well as goods. We firmly believe that increasing these benefits to cover the service sector will greatly benefit the economy as a whole.

We on the Coalition of Services Industries Tax Task Force stand ready and willing to assist your Committee in any way possible.

Thank you for the opportunity to present these remarks.

APPENDIX

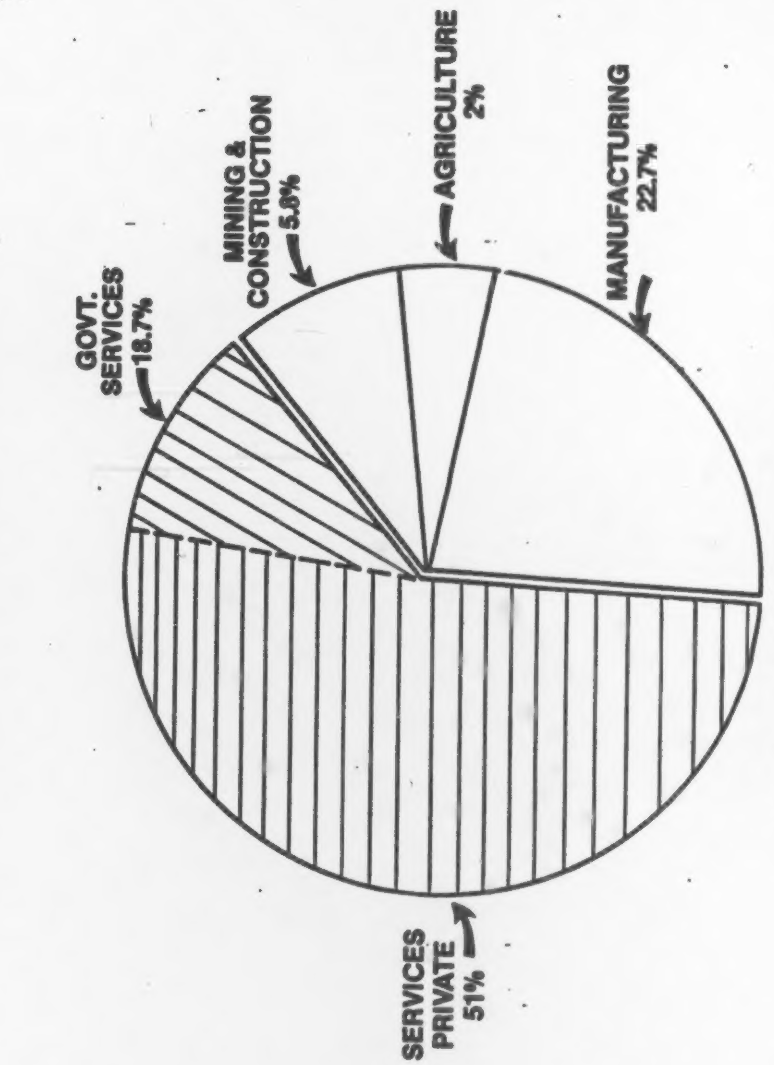
Coalition of Service Industries - Membership List

American Express Company
American International Group, Inc.
American Medical International, Inc.
American Telephone and Telegraph Company
AT&T International, Inc.
ARA Services, Inc.
Archer Daniels Midland Company
Bank of America
Bechtel Power Corporation
Beneficial Management Corporation
CBS, Inc.
Chase Manhattan Bank, N.A.
Cigna (INA)
Citibank, N.A.
The Continental Corporation
Coopers & Lybrand
Deloitte Haskins & Sells
Flexi-Van Corporation
Fluor Corporation
International Business Machines Corporation
The Interpublic Group of Companies, Inc.
Johnson and Higgins
Manpower Inc.
Marsh & McLennan, Inc.
Merrill Lynch & Co., Inc.
Peat, Marwick, Mitchell & Company
Phibro-Salomon, Inc.
Sea-Land Industries Inc.
Sears, Roebuck and Company
Young & Rubicam, Inc.

CHART I

(2)

1981 DISTRIBUTION OF FULL TIME EQUIVALENT EMPLOYEES AMONG INDUSTRIES

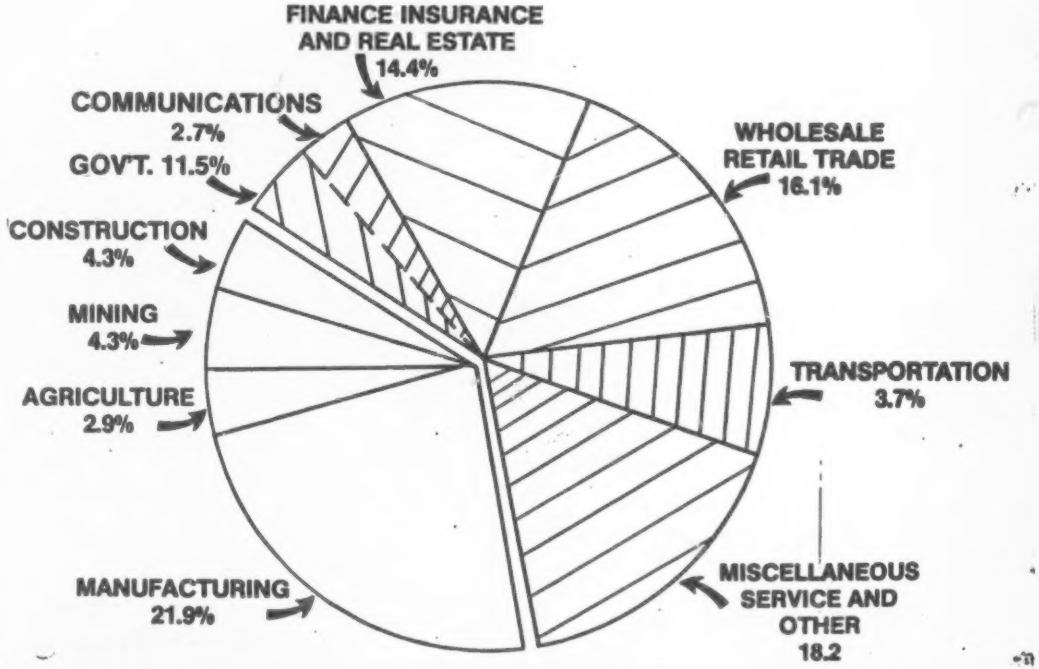


U.S. DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
SURVEY OF CURRENT BUSINESS, JULY 1982, TABLE 6.8B

CHART II

COMPOSITION OF GROSS NATIONAL PRODUCT 1981 (1)

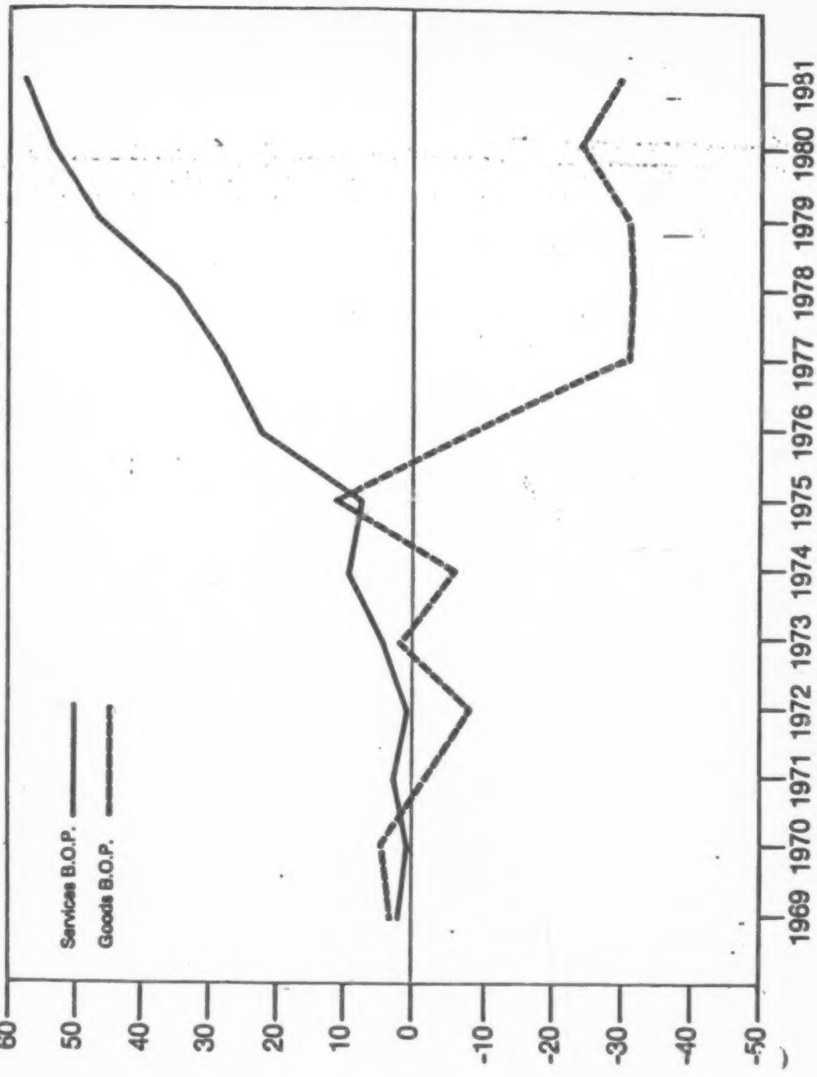
(BILLIONS OF CURRENT DOLLARS)



ALL SERVICES 66.6%
GOVERNMENT 11.5%

U.S. DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
SURVEY OF CURRENT BUSINESS, JULY 1982, p. 78

CHART III



U.S. BALANCE OF TRADE IN GOODS & SERVICES
(Billions of Current Dollars)

Source: U.S. Dept. of Commerce, Survey of Current Business, July 1982, Table 4.1, p. 65.

DOW THE DOW CHEMICAL COMPANY

1800 M STREET, N.W.
WASHINGTON, D.C. 20036

202 457-1700

November 9, 1983

Mr. Roderick A. De Arment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. De Arment:

Attached please find an original and 5 copies of a written statement we would like to submit on the Foreign Sales Corporation Act of 1983 (S. 1804). We would appreciate your inclusion of this statement in the printed hearing record.

Thank you for the consideration of our views.

Sincerely,

Charles T Marck

Charles T. Marck
Vice President and Director
of Government Relations

CTM:asg

Enc.

TESTIMONY OF GLENN W. WHITE
DIRECTOR, TAX DEPARTMENT
THE DOW CHEMICAL COMPANY

BEFORE THE
UNITED STATES SENATE COMMITTEE ON FINANCE

HEARING ON THE
FOREIGN SALES CORPORATION ACT OF 1983
(S. 1804)

NOVEMBER 18, 1983

Mr. Chairman, I am Glenn W. White, Director of the Tax Department of the Dow Chemical Company in Midland, Michigan. Dow Chemical strongly supports legislation which addresses the concerns of the Council of the General Agreements on Tariffs and Trade (GATT) regarding the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code of 1954. We urge Congress to consider and pass such legislation as quickly as possible.

The eleven year dispute in GATT over DISC is not a theoretical issue to Dow Chemical and other major American exporters. We are the people who will suffer commercial losses from lost export sales if our GATT trading partners retaliate against DISC. We are the people who will suffer commercial losses from lost export sales if Canada, the European Communities and other GATT countries impose countervailing duties on our DISC exports. We are the people who will continue to lose sales if United States Government efforts to reduce and eliminate foreign barriers to our exports through GATT procedures fail because of the damage to that system the DISC dispute continues to cause.

During Dow Chemical's last taxable year we exported more than $877 million of goods through our DISC's and were one of the largest DISC users. Approximately $250 million of our DISC exports go to the EC and $121 million to Canada, the two leading critics of DISC.

We are convinced that the EC and Canada will follow through with their threats to retaliate against DISC exports -- which they have a right to do upon authorization of the GATT Council -- if the DISC is not modified in accordance with the December 8, 1981 GATT Council decision on the DISC. Retaliation means quotas or increased tariffs on our exports to those countries and, lost sales to us.

Furthermore, we know it is essential to maintain, if not increase, the current level of tax benefits for export income under DISC. Despite all the attention to promotion of U.S. exports over the last few years, DISC remains the only commercially significant export program available to most exporters. At a time when an overvalued dollar and foreign trade barriers are damaging U.S. export performance, it would be a severe blow to U.S. exporters to increase the level of taxation on export income.

For these reasons, Dow Chemical generally supports the Administration proposal, the Foreign Sales Corporation Act of 1983 (S. 1804), as a viable, acceptable and, under the circumstances, essential alternative to DISC. S. 1804 should permit the United States Government to resolve the DISC dispute through acceptable means. S. 1804 will permit many DISC users to continue to export from the United States rather than moving production to foreign markets, thereby preserving U.S. jobs; it will continue the incentive to invest in export related assets; it will not significantly disrupt the structure and operation of U.S. export trade developed under DISC; and, it is conceptually a territorial income tax system, which not only complies with GATT, but is also in the long term interests of the United States.

Dow Chemical has some reservations about S. 1804 as introduced which we believe this Committee can easily address when it considers the bill (1) The foreign presence requirements may be more burdensome than similar requirements under foreign tax systems on which S. 1804 is modeled. (2) There may be additional suggestions to benefit small businesses beyond those already in the bill. (3) Futhermore, the so-called "factoring" provision in section 2(c) of the bill has implications that go far beyond DISC or Foreign Sales Corporations. We strongly believe this issue should be considered separately on its merits and not confused with the FSC issue.

Despite these reservations, Dow Chemical strongly supports the Foreign Sales Corporation Act of 1983 and urges this Committee to act on the measures as soon as possible.

TECHNICAL COMMENTS ON THE ADMINISTRATION'S FOREIGH SALES CORPORATION PROPOSAL (S.1804)

Not all of the following technical comments bear directly on Dow Chemical Company's ability to utilize the Foreign Sales Corporation provisions. A number of comments, instead, are intended to improve the proposal in order to make it useful for as many potential exporters as possible, given generally accepted tax policy and revenue restraints.

1. Qualifications of a Foreign Sales corporation

a. Foreign Office Requirement

The bill does not make clear whether a foreign office, which is a requirement, may be shared with one or more unrelated business enterprises. It is also unclear whether personnel in a foreign office may be shared. For smaller exporters especially, the ability to share an office and personnel may be very important.

b. Foreign Books and Records Test

An FSC must maintain a set of the permanent books of account of the corporation at its foreign office. The term "permanent books of account" is not defined. Accounting records that satisfy the local taxing authorities in the jurisdiction of incorporation of the FSC should suffice for purposes of this requirement.

c. Multiple - FSCs

While the proposal permits up to 25 unrelated shareholders to participate in the same FSC and does not prohibit different classes of stock (so long as preferred stock is not outstanding), the absence of patronage-like rules makes it difficult for groups of exporters to band together in a single FSC that might operate somewhat like a trading company.

2. Pricing Rules

Under the combined taxable income method of determining a transfer price, a Foreign Sales Corporation may be allocated 23% of combined taxable income attributable to a qualifying sale. Of this 23%, 17% will qualify as exempt foreign trading income. The remaining 6%, however, is treated as U.S. source income effectively connected with the conduct of a U.S. trade or business conducted through a U.S. permanent establishment and thus subjected to U.S. tax in the hands of the FSC. The source of this 6% of combined taxable income should be determined under existing U.S. sourcing rules rather than automatically characterized as U.S. source income. Moreover, while this income is appropriately subjected to U.S. taxation, it should be taxed in the hands of the FSC's shareholder (ordinarily a U.S. parent corporation) rather than taxed to the FSC. Under the existing DISC provisions, all income subject to taxation is subject to taxation at the shareholder level so that any shareholder losses, depreciation, deductions, etc. can be fully utilized. Similar treatment should be afforded here.

3. Foreign Presence

We understand that the Administration is presently developing a detailed description of how the foreign presence rules would operate. We believe it is intended that exporters be able to comply with the Administration's foreign presence requirements without excessive disruption to their current business practices. Until this description is made public, we are unable to comment further.

4. Factoring of Receivables

The bill makes clear that any interest or carrying charges of any type earned by an FSC will be subject to current U.S. taxation first in the hands of the FSC and again when distributed to the U.S. shareholder. No dividends received deduction is available to a U.S. corporate shareholder and, of course, none is available to an individed shareholder. Thus an FSC cannot factor receivables because the resulting income would be taxed not once but twice. It follows that the anti-factoring provision contained in the bill is not aimed at FSCs but other entities and activities.

Many companies that currently factor receivables overseas do not have DISCs and will not create FSCs. Yet these companies understandably may wish to object to all or some aspects of the proposed factoring provisions. The debate concerning this subject should take place apart from the consideration of the FSC proposal.

5. Effective Date and Transitional Rules

While we believe that the ability to make use of an FSC should commence upon passage of the bill, we understand that not every exporter is in a position to immediately take advantage of the provisions. Accordingly, a reasonable transition period and accompanying rules for items such as long-term contracts should be provided. Special rules for the tax-free transfer of assets from a DISC or other domestic or foreign entities to an FSC also should be added.

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D. C.

Comments regarding United States Senate Committee on Finance Hearing on November 18, 1983 concerning a Bill to Amend the United States Internal Revenue Code with Respect to the Tax Treatment of Foreign Sales Corporations (the "Foreign Sales Corporation Act of 1983")

Paul H. DeLaney, Jr.
Lord, Day & Lord
1120 Twentieth Street, N. W.
Suite South 710
Washington, D. C. 20036
(202) 785-1766

Comments regarding United States Senate Committee on Finance Hearing on November 18, 1983 concerning a Bill to Amend the United States Internal Revenue Code with Respect to the Tax Treatment of Foreign Sales Corporations (the "Foreign Sales Corporation Act of 1983")

INTRODUCTION AND SUMMARY

In accordance with Press Release No. 83-199 issued by the United States Senate Committee on Finance on November 7, 1983, the purpose of this memorandum is to provide comments regarding the Senate Finance Committee's hearing on November 18, 1983 concerning a bill to amend the United States Internal Revenue Code with respect to the tax treatment of foreign sales corporations (the "Foreign Sales Corporation Act of 1983").

At the outset, we wish to confirm our continuing interest in, and support for, the efforts of the Members and staff of the Senate Finance Committee and the House Ways and Means Committee, the staff of the Joint Committee on Taxation, officials of the Office of the United States Trade Representative, and officials of the United States Department of the Treasury directed to resolving the complex issues which have arisen over a number of years regarding possible legislative revision of the United States Domestic International Sales Corporation ("DISC") in the context of United States commitments and understandings with respect to ongoing General Agreement on Tariffs and Trade ("GATT") proceedings.

As related to the Senate Finance Committee in the past, we wish to express our particular concern about certain issues which are important to United States agricultural interests if the present DISC provisions are modified in the future. In this regard, agricultural commodities trading in international markets is highly competitive with traditionally large volume transactions involving low profit margins. Accordingly, any DISC legislative proposal which does not properly address these international business realities could be detrimental to United States farmers and United States agricultural exporters. Based on extensive consideration in recent months of proposed legislative techniques to revise DISC, it appears that more attention has now been focused on assuring that United States agricultural exports would not be subjected to a higher effective rate of United States taxation under substitute provisions for DISC. Nevertheless, we wish to stress again that any modified DISC should take into account the traditional nature of transactions involving firms engaged in international trading of agricultural commodities so as to preserve the competitiveness of United States interests in international markets.

We also wish to confirm that United States agricultural interests are also concerned about transitional rules regarding any prospective revision of DISC, particularly with respect to the matter of previously accumulated tax-deferred DISC income.

Finally, we wish to suggest that as the Senate Finance Committee and the House Ways and Means Committee proceed with their deliberations in this area, continued emphasis should be directed to the potential benefits of utilizing a concept of territorial equivalence in order to maximize the prospects of the United States defending any modified DISC in the context of the GATT proceedings.

DISCUSSION

Historical Considerations

DISC Provisions as Originally Enacted under the Revenue Act of 1971

Under United States tax law, a system of deferral is provided for a corporation known as the DISC and its shareholders. [1] In accordance with the initial enabling legislation, pursuant to provisions of the Revenue Act of 1971, the profits of a DISC were not taxed to the DISC, but were taxed to the shareholders of the DISC when distributed. Each year a DISC was deemed to have distributed income representing 50 percent of its profits, thereby subjecting that income to current taxation in the hands of shareholders. In this way the tax deferral which was available under DISC provisions was limited to 50 percent of the export income of the DISC.

In order to qualify as a DISC, at least 95 percent of a corporation's assets must be export-related and at least 95 percent of a corporation's gross income must arise from export sale or lease transactions and other export-related activities.

1/ The DISC provisions were initially enacted into law pursuant to the Revenue Act of 1971, P.L. 92-178, 92nd Cong., 1st Sess., 85 Stat. 497, December 10, 1971.

Qualified export receipts include receipts from the sale of export property, which generally means property such as inventory manufactured or produced in the United States and held for sale for direct use, consumption or disposition outside the United States.

Initiation of Formal GATT Complaints in 1973 Involving the United States DISC and Certain Tax Practices of France, Belgium and the Netherlands

In July 1973 a panel was established to examine a complaint submitted by the European Communities ("EC"), pursuant to paragraph 2 of Article XXIII of the GATT, relating to the United States DISC, and to make such findings as would assist the Contracting Parties of GATT to make recommendations or rulings provided for in paragraph 2 of Article XXIII of GATT (this panel is sometimes hereinafter referred to as the "GATT DISC Panel").

The EC asked the GATT DISC Panel to find that the DISC system was incompatible with the relevant clauses of GATT regarding export subsidies. In the course of its proceedings, the GATT DISC Panel held consultations with the EC and the United States and background arguments and information were submitted by both parties.

In response to the EC complaint, the United States initiated counter-claims and proceedings against certain tax practices of France, Belgium and the Netherlands alleging that such tax practices constituted export subsidies in violation of

GATT. Separate GATT panels were established in July 1973 to examine the United States' complaints with respect to each of the subject countries, pursuant to paragraph 2 of Article XXIII of the GATT, and to make recommendations or rulings provided for in paragraph 2 of Article XXIII of the GATT (these panels are sometimes hereinafter collectively referred to as the "GATT European Tax Practices Panels").

DISC Provisions Under the Tax Reform Act of 1976

During the course of 1975, the House Ways and Means Committee and the full House considered various tax reduction and tax reform matters. Owing to timing considerations, the Senate Finance Committee directed its immediate attention to the tax reduction provisions of the 1975 House bill and did not undertake consideration of the tax reform provisions of the bill until 1976. Accordingly, the House proposed modifications to DISC were not considered in the Senate until 1976.

Under the House bill, incremental rules were adopted for taxable years beginning after December 31, 1975, which would have permitted DISC benefits to the extent that current export gross receipts exceeded 75 percent of the average for a 3 year moving base period (initially 1972-1974) which would move forward after 1980.

The Senate Finance Committee began hearings in March 1976 on major tax revision proposals and extension of expiring tax cut provisions. The Committee reported out a bill for consideration of the full Senate in June 1976. [2]

Under the amendments to the House bill adopted by the Senate Finance Committee and the full Senate, the incremental rule limited DISC benefits to the extent that current export gross receipts exceeded 60 percent of the average for 3 out of 4 base period years (initially 1973-1976) which would move forward after 1979. [3]

Under this statute, as ultimately enacted into law, the incremental rule applies to taxable years beginning after December 31, 1975, and is 67 percent of the average gross receipts for a 4 year base period (initially 1972-1975) which moves forward after 1979. In addition to the United States Congress adopting an incremental approach for DISC benefits, it is also important to note that the Senate Finance Committee, and the Congress as a whole, were fully aware of the importance of continuing to encourage United States exports of agricultural commodities through the DISC and other means. On October 4, 1976, the President signed into law the Tax Reform Act of 1976. [4]

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[2] See Report of the Senate Finance Committee accompanying H.R. 10612, S. Rep. No. 94-938, 94th Cong., 2d Sess., June 10, 1976.

[3] See Report of the Senate Finance Committee accompanying H.R. 10612, S. Rep. No. 94-938, 94th Cong., 2d Sess. at 293-294, June 10, 1976.

[4] See Tax Reform Act of 1976, P.L. 94-455, 94th Cong., 2d Sess., 90 Stat. 1510, October 4, 1976.

Findings and Determinations of the GATT DISC Panel and the GATT European Tax Practices Panels

In November 1976, the GATT DISC Panel concluded that the DISC legislation, in some cases, had effects which were not in accordance with United States obligations under Article XVI(4) of GATT and that, as it had found the DISC legislation to constitute an export subsidy which had led to an increase in exports, it was also covered by the notification obligation contained in Article XVI(1) of GATT and accordingly, there was *prima facie* case of nullification or impairment of benefits under GATT.

In November 1976, the GATT European Tax Practices Panels concluded that the tax practices of France, Belgium and the Netherlands, in some cases, had effects which were in conflict with the respective obligations of these countries under GATT Article XVI(4) and that, since these practices had been found to constitute export subsidies which had led to an increase in exports, it was also covered by the notification obligations contained in Article XVI(1) of GATT and accordingly, there were *prima facie* cases of nullification or impairment of benefits under GATT with respect to the subject practices of each of these countries.

Subsequent GATT Proceedings Involving United States DISC and Certain Tax Practices of European Countries and United States Legislative Developments

The United States and the EC have negotiated for many years concerning the possible resolution of the now longstanding disputes involving the decisions and reports of the GATT DISC Panel and the GATT European Tax Practices Panels..

In December 1981, the GATT Council adopted all four of the panel reports with respect to the findings of the GATT DISC Panel and the GATT European Tax Practices Panels with certain specific qualifications. It should be noted that these determinations by the GATT Council did not, in fact, effectively resolve the subject disputes, but rather provided a new procedural means for pursuing a new form of negotiated settlement in the future.

In this regard, after extensive consultations carried out on the United States' part by the Office of the United States Trade Representative, certain understandings and conclusions were reached which resulted in the Executive Branch of the United States federal government determining that it would propose legislation to modify the DISC taking into account relevant GATT concerns. Accordingly, in August 1983, at the request of the Administration, identical bills were introduced in the Senate and House (S. 1804 and H.R. 3810) for the subject purposes. 5/

Present Specific Concerns of United States Agricultural Interests

Over a period of years, various United States agricultural interests have stressed the need to retain the

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5/ See Congressional Record, Vol. 129, No. 114, 98th Cong., 1st Sess. at S-11714 and H-6606, August 4, 1983.

competitive position of United States agricultural exports in world markets. Furthermore, it has been stressed that international trading of agricultural commodities is a highly competitive business, traditionally involving complex, large volume, low profit margin transactions. Therefore, in assessing any possible changes to DISC, it is extremely important that these international business realities be given due consideration; otherwise, it is entirely possible that legislative changes to DISC could be detrimental to United States farmers and United States agricultural exporters. If the United States is to preserve the competitive position of United States firms engaged in exports of United States agricultural commodities, it is important to recognize that these high volume, low profit margin transactions in international commerce offer limited, if any, opportunity for absorbing additional tax costs. It should also be noted that various foreign governments subsidize exports of their own agricultural commodities by means of financial and tax benefits. In this regard, countries with territorial tax systems often enable their exporters to avoid local income taxes by generating trading profits abroad. Accordingly, such tax benefits provided by foreign governments to their exporters place United States exporters of United States agricultural commodities at a competitive disadvantage.

In a general sense, it is also important to recognize that United States exports of agricultural commodities have been declining in recent years in both absolute and relative terms, and that if the United States is to recapture these export markets, it is important to at least retain tax benefits comparable to those under the present DISC provisions. Unless the considerations noted above can be satisfied, it is to be expected that the United States trade deficit will continue to grow at the enormous rate of recent years, with discouraging consequences, including the loss of United States jobs and other adverse results for the United States economy.

Furthermore, based on the considerations noted above, it is important to realize that United States agricultural interests could also be substantially affected by transitional rules regarding any prospective revision of DISC, particularly with respect to the matter of previously accumulated tax-deferred DISC income. In this regard, if new legislation were enacted which would penalize United States firms which have exported United States agricultural commodities in the past, it is to be expected that this would reduce the prospect of such firms remaining competitive in the future.

Recognizing that United States agricultural interests are also familiar with other ongoing international trade problems under GATT and that, given the long history of the DISC and related proceedings in GATT, it is suggested that the United States Congress give considerable weight to the need for further emphasis on the potential benefits of utilizing the concept of territorial equivalence in order to maximize prospects for the United States defending any modified DISC at the GATT.

CONCLUSION AND RECOMMENDATIONS

Based on the points, authorities, developments and considerations set forth above, we urge the Senate Finance Committee to continue its ongoing efforts to assure the competitiveness of United States agricultural exports in assessing any proposed modifications to the DISC provisions of the United States Internal Revenue Code. More specifically, we recommend that the Senate Finance Committee take into account the traditionally large volume, low profit margin transactions of firms that export United States agricultural commodities. It is also suggested that the Senate Finance Committee give careful consideration to any transitional rules regarding prospective revision of DISC, particularly with respect to the matter of previously accumulated tax-deferred DISC income. Finally, we recommend that as the Senate Finance Committee proceeds with its deliberations in this area, continued emphasis be directed to the potential benefits of utilizing a concept of territorial equivalence in order to maximize the prospects of the United States defending any modified DISC in the context of the GATT proceedings.

December 9, 1983

Respectfully submitted,

Paul H. DeLaney, Jr.
Lord, Day & Lord

MAYER, BROWN & PLATT
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CABLE LEMAYDC

December 9, 1983

By Hand

The Honorable Robert J. Dole
Chairman
Committee on Finance
U. S. Senate
221 Senate Dirksen Office Building
Washington, D. C. 20510

Re: November 18, 1983, Hearing on Foreign Sales Corporation Act (S. 1804) and Its Application to Webb-Pomerene Corporations and Their Members

Dear Mr. Chairman:

This is to suggest for the record of your hearing that it is important that this bill and its history make it clear that the benefits of this legislation will be available both to Webb-Pomerene corporations and to their members which might choose to sell to Webb-Pomerene corporations through affiliated Foreign Sales Corporations ("FSCs").

As you may know, Webb-Pomerene organizations may be organized as associations or corporations in accordance with the 1918 Webb-Pomerene Export Trade Act. Some forty Webb-Pomerene export organizations are now registered with the Federal Trade Commission.

Both the DISC and the Webb-Pomerene legislation were intended to encourage exports. Thus, it is appropriate that the DISC Handbook for Exporters released by the Treasury Department on January 24, 1972, made it clear that a Webb-Pomerene organization can be a DISC provided it is organized as a corporation. (A copy of the relevant portion of the handbook is attached for your convenience.)

The Honorable Robert J. Dole
Page Two
December 9, 1983

Webb-Pomerene associations and their members have benefited from the DISC legislation, and it is our understanding that the policy of the pending legislation is to substitute FSCs for DISCs. Nevertheless, it is important to assure that this policy is reflected in the technical language of the bill as it would affect Webb-Pomerene corporations.

We would, of course, welcome the opportunity to answer any questions and to confer with your staff regarding technical matters.

Respectfully,

Jerry L. Oppenheimer

JLO/sr
Enclosure

DISC

MADE IN USA
DISC

Domestic International Sales Corporation

a handbook for EXPORTERS

or from unrelated DISCs, or (2) sell on a commission basis for such persons. A DISC can also manage the export activities of unrelated DISCs. Where the best course for a business has been to export through an independent distributor, there is no reason why such an arrangement should not continue. It might be advantageous for the business to organize its own DISC which would in turn export through an independent distributor.

How can a small businessman use a DISC?

A small businessman can use a DISC with a minimum of difficulty even though a DISC must be a corporation. For example, a small manufacturer can with little difficulty organize a DISC with $2,500 of capital and have it act as a commission agent on export sales.

I have never exported before. Can a DISC be of benefit to me?

The Government would like to encourage persons to export who never exported before and DISC should prove helpful in this. There is a minimum of formality required to set up and operate a DISC. The Commerce Department has experts in its National Office and its 42 field offices who are available with advice and information for the new exporter. Commerce will provide information on economic conditions, foreign markets, specific export opportunities, and U.S. Government sponsored commercial exhibitions abroad. Financing for U.S. exports is available through commercial banks and the Export-Import Bank which, along with Commerce, will supply information on export loans, guarantees and insurance. The telephone number of the National Office of the Commerce Department is (area code 202) 967–3181.

Can a group of small producers set up a DISC?

Yes. There are no limitations or requirements as to the number of shareholders, and a DISC can handle the exports of any number of United States producers whether related or unrelated. It is contemplated that in many instances several small producers will arrange among themselves to export through a jointly owned DISC.

Can a Webb-Pomerene Association be a DISC?

Yes, provided it is organized as a corporation. If the association is not in corporate form it may reorganize as a corporation and readily qualify as a DISC. A Webb-Pomerene Association which qualifies as a DISC would have one-half of the Federal income tax on its export earnings deferred and could make "producer's loans" to its member companies or other export producers.

Business necessity requires me to keep my foreign selling organization. Would a DISC be of benefit to me?

Yes; for example, a U.S. producer that has a foreign selling subsidiary or an independent foreign distributor which it intends to keep, will generally find it advantageous to have a DISC to act either as agent or principal on sales to its foreign subsidiary or distributor.

I already have an export department that I intend to maintain. Would a DISC be of benefit to me?

Yes. One of the advantages of also forming a DISC is the simplified allocation method that would be available.

What property can a DISC export?

Property manufactured, produced, grown or extracted in the United States (including Puerto Rico and the possessions of the United States) qualifies for sale through a DISC. At least 50 percent of its value must be attributable to United States content. Components and finished products, agricultural commodities and minerals would be qualified DISC exports. However, property which benefits from certain government export subsidies, or which has been declared by the President to be in short supply in the United States, would not qualify. As yet, no property has been declared to be in short supply for this purpose.

What is an export?

In the case of a sale, the property must be delivered outside of the United States for use outside of the United States. In the case of a lease, the place where the property is used determines whether there is an export.

To whom may a DISC sell?

A DISC may sell to any related or unrelated person where the property is to be delivered outside the United States for use outside the United States. A DISC may also sell and make delivery in the United States to a second DISC for export by the second DISC if the two DISCs are unrelated. Sales to other persons by a DISC for delivery in the United States will qualify only if they are unrelated and it is established that after the sale by the DISC there is no further sale, use or processing within the United States

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STATEMENT

by the

NATIONAL COTTON COUNCIL OF AMERICA
1030 15th Street, N.W., Suite 700
Washington, D.C. 20005

to be included in the record of the hearing held

by the

COMMITTEE ON FINANCE
UNITED STATES SENATE

on

Friday, November 18, 1983
SD-219 Dirksen Senate
Office Building

regarding

S. 1804, THE FOREIGN SALES CORPORATION ACT OF 1983

I. Introduction

The National Cotton Council is the central organization of the U.S. cotton industry, representing producers, ginners, warehousemen, merchants, cooperatives, cottonseed crushers, and textile manufacturers. Its members export raw cotton, cottonseed, cottonseed products, and textile mill products. Accordingly, the Council is deeply interested in the proposal to repeal the Domestic International Sales Corporation program (DISC) and replace it with the Foreign Sales Corporation program (FSC).

II. Summary of Statement

The Council believes the present DISC program is not in violation of U.S. obligations under the General Agreement on Tariffs and Trade (GATT), and urges that it be retained in its present form. However, if overriding political considerations make it necessary to repeal DISC, the Council urges the Committee to consider the points below as it reviews S. 1804, which would substitute the FSC program for DISC.

(1.) Under FSC, two "small business" exceptions are proposed -- an "interest-charge DISC" with $10 million or less in qualified export receipts, and a "small FSC" with receipts of $2.5 million or less. The Council believes these limitations -- which would allow the sale of only about 28,000 and 7,000 bales of cotton, respectively, at current prices -- are too restrictive and should be substantially increased.

(2.) The requirement that payments must be received outside the U.S. is unworkable. As a minimum, it should be permissible to deposit payments in a domestic bank account of a FSC.

(3.) The Council believes many medium-size exporters with sales too large to qualify for the small business exceptions will be unable to afford the costs involved in actively managing a FSC. We urge that Congress clearly indicate its intent to interpret broadly the economic processes which may be carried out for a FSC under contract by another.

III. Statement

Almost from the time of its inception in 1972, the DISC program has been attacked by the European Community, and more recently Canada, as an export subsidy and therefore a violation of the GATT. The concept of "territorial taxation" lies at the heart of this argument. The U.S. taxes the entire worldwide income of its domestic corporations, and allows a credit against U.S. tax for income taxes paid abroad. Practically no other country follows this policy. The U.S. government has stated repeatedly that the purpose of the DISC program in deferring part of U.S. exporters' tax is to establish equality with other exporting countries who do not tax similar export earnings.

When DISC was first attacked, the U.S. reviewed tax policies of the member states of the European Community. It concluded that the policies of at least three (France, Belgium, and The Netherlands) were in violation of the GATT, and brought complaints against them.

Under GATT procedures, a panel of experts is established to study complaints and make recommendations to the GATT Council. Panel reports have no effect unless and until they are "adopted" by the GATT Council.

Four panels were established in 1972 to study the four complaints. Their findings, eventually issued in 1976, concluded that all four complaints were valid and the policies cited were in violation of the GATT. However, it is important to note that the panel findings were not immediately adopted by the GATT Council. Many GATT specialists have consistently termed the findings wrong because they were based upon a rule of law no longer considered valid, if it ever was -- i.e., that territorial taxation is not valid and a GATT member must tax export sales to the point of sale to the first independent buyer.

The four panel reports remained in limbo until December 8, 1981, when the GATT Council finally adopted them with a qualification accepting the principle that an exporting country need not tax economic activities involving exported goods located outside its territorial boundaries. Furthermore, the U.S. read the following statement into the record:

> "It is our view that the U.S. global system of taxing export sales -- inclusive of the DISC provisions -- is consistent with this principle, and hence, is defensible under GATT rules."

For these reasons, the Council believes the DISC program is not a violation of the GATT and urges that it be retained. However, we recognize that considerations based upon the totality of our trade relations, rather than technical compliance with the GATT, can necessitate a change. In that event, we urge consideration of the following points in reviewing the proposal to substitute the FSC program for DISC:

(1.) Under the FSC proposal, a DISC with $10 million or less in qualified export receipts may elect to continue to be treated as a DISC, but the tax otherwise due on the deferred income will be subject to an interest charge based on the Treasury bill rate. Alternatively, if a FSC has foreign trading gross receipts of $2.5 million or less, it may elect to use the administrative allocation rules to establish arm's-length pricing without meeting certain foreign presence requirements.

In our view, these small business exceptions are too restrictive and will prohibit many medium-size exporters from taking advantage of the FSC program. They will not be able to compete on a cost basis with large exporters who already have corporations in place in other countries and can adapt to the FSC rules relatively easily. They also will be at a disadvantage compared with small exporters who can use the small business exceptions that will only cover sales of about 28,000 and 7,000 bales of cotton, respectively, at current prices. We believe the best solution is a substantial increase in the limitations on the small business exceptions.

(2.) The requirement that payments be received outside the U.S. is contrary to long-standing practice, adds unnecessary costs to the operation of a FSC, and will have side-effects distorting normal banking relationships.

International transfers of funds are costly. Normally a day will be lost for each bank through which the money passes. Over a series of transactions, these transfers will add up to a substantial hidden cost. Admittedly, this cost could be avoided by maintaining the FSC's bank accounts at domestic banks' foreign branches, but this would lead to a substantial windfall for the international banks who can offer accounts almost anywhere. The realignment of account relationships between banks and customers is not a proper purpose for this legislation, but could very well be the result.

A large proportion of international payments is made under letters of credit. It is both common practice and cost efficient to have the beneficiary of a letter of credit and the paying bank in the same country. The foreign payment requirement would seem to mean that either U.S. banks would have to transfer funds to foreign bank accounts, or U.S. export letters of credit would have to be negotiated by foreign banks. Neither alternative is attractive.

In short, requiring payments to be received outside the U.S. would disrupt banking relationships. The only winners would be the large international banks. The requirement also would disrupt letter of credit transactions. Most important of all, it would add unnecessary costs which could greatly reduce American firms' ability to compete in world markets while operating under FSC -- a result exactly opposite to that intended by this legislation.

(3.) Even if the proposed limitations on the two small business exceptions are increased as we have recommended, there will always be exporters whose sales exceed the limitations but are not large enough to justify the costs of operating a FSC. In order for these companies to compete on a fair basis with both the large international exporters and with those qualifying for the small business exceptions, it should be made clear that all activities of a FSC -- except those listed in Section 922 to qualify as a FSC -- can be carried out for the FSC under contract by another party either in the U.S. or elsewhere.

Both the General Explanation of FSC, dated June 9, 1983, and the Technical Explanation dated June 14, 1983, gave broad interpretations to the activities which can be carried out for a FSC under contract by another party. They also indicated that those activities not necessary to qualify as a FSC under Section 922 can be performed in the U.S. or elsewhere. Unfortunately, while S. 1804 contains numerous references to the contracting of FSC activities, it is less specific than the earlier papers. We believe it is imperative to change either the language of the bill itself to indicate that Congress intended to broadly interpret the use of contracting by a FSC, or to show that intent clearly in the bill's legislative history.

Respectfully submitted,
National Cotton Council of America

Earl W. Sears
Earl W. Sears
Executive Vice President

STATEMENT OF

ROBERT J. PATRICK, JR.

ON BEHALF OF

PRICE WATERHOUSE

ON

THE FOREIGN SALES CORPORATION ACT

BEFORE THE UNITED STATES SENATE

COMMITTEE ON FINANCE

November 18, 1983

Mr. Chairman, I am Robert J. Patrick, Jr., Washington Director of International Tax Practice for Price Waterhouse. I am pleased to appear this morning to testify on S. 1804, which would amend the Internal Revenue Code to substitute Foreign Sales Corporations ("FSC") for the present Domestic International Sales Corporations ("DISC") provisions of the Internal Revenue Code.

It is important to place the significance of this proposal in perspective. During these hearings and in subsequent consideration of the FSC, the Committee will hear debate about the FSC as a matter of tax policy, and, as in this testimony, the Committee will receive technical comments on its details. The FSC's real significance, however, is that, viewed as a trade proposal, it signifies the U.S. government's intention, within the limits of international agreements, to promote the expansion of U.S. exports and to accept the challenge of international competition rather than falling back upon protectionism.

The U.S. should lead in the expansion of export trade. The FSC has been developed within domestic and international constraints that have precluded a broader review of U.S. export tax policy applicable to goods, services and investments. We should deal expeditiously with this specific matter, but should not continue to neglect a broader based U.S. export program.

Price Waterhouse supports trade and tax policies that permit U.S. exporters to compete on terms available to their international competition. We believe that the FSC legislation is intended to facilitate that result. According to the most recent Treasury Report on DISC, more than 70 percent of exports of U.S. manufactured goods and an even larger percentage of agricultural commodities move through DISC's. A proposed substitution of the FSC for the DISC is significant to U.S. exporters.

Relationship to GATT Rules

The impetus for the FSC proposal and the form it has taken have been dictated by arbitrary ground rules that are not wholly compatible. First, the initiative is a direct response to negotiations under the auspices of the GATT with respect to the trade rules applicable to the income taxation of exports, which led to a U.S. commitment to modify its existing legislation to meet the concerns of other GATT members. Second, the present economic situation has required observance of revenue neutrality in designing a structural change. Third, the distribution of tax benefits among existing exporters using DISC's is intended to be maintained to the greatest extent possible, including benefits for smaller exporters.

The December, 1981 GATT understanding with respect to income taxation of export profits validated territorial tax systems employed by some foreign trading partners of the United States. Such tax rules had been found objectionable in the GATT panel reports which had also objected to the U.S. DISC provisions. Pursuant to the interpretation of the trade rules, the country of origin of exports is not required to tax the income from an economic process occuring outside of its territory, provided that related company transactions are conducted on an arms-length basis. The FSC proposal has been designed to incorporate a territorial taxation principle in U.S. tax laws analogous to rules imposed in certain foreign countries. From the U.S. trade policy standpoint, the FSC proposal reflects an effort to permit U.S. exporters to operate under the most favorable income taxation rules applicable to the competition. From a tax policy standpoint, there has been longstanding U.S. debate concerning the appropriate taxation of export income. Should such income be taxed exactly like domestic income, or subject to the tax deferral rules applicable to the unrepatriated income of U.S. controlled foreign manufacturing, or taxed in a manner similar to the territorial exemption provided under some foreign tax systems? The objections of U.S. trading partners to the DISC deferral system, together with the sanctioning of territorial exemption for trade purposes, has led to a proposal to adopt the latter as U.S. law.

The Treasury Department and the Office of the U.S.Trade Representative have consulted with the U.S. export community and have made every effort to develop a proposal that meets the constraints of GATT, revenue neutrality, and comparable benefit distribution. There was considerable reluctance on the part of U.S. exporters to see a requirement of foreign incorporation and gradual acceptance of such a requirement followed assurances by the U.S. representatives that such a step was necessary to meet the objections of other GATT members. The business concerns about a foreign incorporation requirement were similar to those of the Congress in 1971 when it provided for domestic incorporation under the DISC tax system, rather than foreign incorporation. Other factors being equal U.S. incorporation seemed more sensible and more efficient.

The FSC proposal contemplates two basic methods of operation, in addition to special rules for small exporters. One alternative permits a foreign off-shore sales subsidiary, organized in U.S. territories that are outside of the U.S. customs territory or in foreign countries, to be entitled to earn an arms-length selling profit on the distribution of U.S. goods and certain services abroad. This proposal appears fully consistent with the GATT understanding as to the applicable trade law rules. The contemplated deferral of U.S. tax on export income at the foreign corporate level has antecedents in the Export Trade Corporation rules in the Revenue Act of 1962 and in the considerably more liberalized rules of DISC itself. The FSC proposal introduces an intercompany dividends received deduction to exempt a portion of such income upon repatriation to the U.S.

The second option permits a FSC, again organized in certain territories or in a foreign country, to receive a portion of the combined taxable income of the FSC and its related supplier based upon the FSC undertaking certain sales related activities and performing certain of these activities outside of the U.S. The FSC, under this regime, is entitled to employ administrative pricing rules which relate the amount of sales activity of the FSC to an allocation of profits to the FSC. The degree of such sales activity occuring outside of the United States, in turn, determines the amount of income that may be exempt from tax under application of the foreign economic process concept of the trade rules. For many companies, particularly those with operations that make it difficult to turn all of their selling activities over to an overseas affiliate, the administrative pricing rules would permit accommodation to the new system.

The Need for Administrative Certainty

The U.S., however, is in the unique position of being the first country to attempt to define the concept of a foreign economic process. This presents a number of practical issues for the administration of the proposed system. Rules that are adopted should be designed to be administratively workable, providing adequate guidance and certainty for the IRS and the taxpayer. Experience of operating under the DISC rules, which became administratively more complex than originally envisaged, reinforces the argument for practical rules that meet this criterion and which avoid disruption of existing customer relations and distribution systems. In that connection, most of the rules that have been set forth are framed to apply to a buy/sell relationship while, based upon DISC experience, many FSC's may operate on a less disruptive commission basis.

The Congress and the Administration in refining this proposal should concentrate on steps that can be taken to simplify its administration. This is particularly true with respect to the administrative pricing rules. For example, with respect to the requirements that the FSC be engaged in the solicitation, negotiation, or the making of contracts, there is a need for guidance as to the recordkeeping or other means of establishing the nexus of such FSC participation and the ultimate sales. There are a number of terms utilized for qualification tests which are not inherently distinct activities, such as "negotiation," "solicitation," "advertising," and "sales promotion. Specific cost accounting tests are to be applied as if these were always discreet activities. Vagueness will create major uncertainties. Similarly, there should be precise definitions of the relevant costs of the FSC and its affiliates that are to be considered in order to determine the percentage of expenditures that must be met as foreign incurred expenses. It will also be important to consider the requirements for FSC activities where they are undertaken not in the context of an FSC that buys export property and resells it, but in the case of the FSC acting as a commission agent.

Possible Structural Revision

There are several aspects of the proposed FSC structure and collateral rules that warrent further consideration.

Sales Companies under Section 482. As noted, one of the intercompany pricing alternatives is based upon arms length transactions with a foreign related or unrelated entity operating as an independent sales company. Even in this case there is a limit on the tax benefit that can be realized, presumably in the light of the present revenue constraint. It should be noted that this need not be an inherent limitation in the future. In addition, the detailed foreign economic tests are apparently contemplated as requirements for such companies. It is not readily apparent why sales companies meeting the arms length requirements of the Internal Revenue Code (Section 482), and which conduct all of their business outside of the U.S., could not operate under more traditional rules, for example, simply deeming their non-exempt export income to be taxable under Subpart F and retaining the source of income rules of taxation presently found in the Internal Revenue Code.

Cliff Problem. For those using the administrative pricing rules, the present proposal provides pass or fail tests requiring the FSC meeting precise percentages of selling costs being incurred outside of the U.S. It would be appropriate to consider whether a total loss of benefits should result from possible cost allocation adjustments.

Foreign Tax Credits and Foreign Source Income. In addition, the source of income and foreign tax credit rules for all FSCs, should be revised to provide that what would be non-effectively connected foreign source income under the present rules of the Internal Revenue Code can carry creditable foreign income taxes.

Small Exporters. The FSC proposal reflects an effort to address the significant problems that a small exporter would have in attempting to operate through the foreign corporation requirements. The alternatives envisaged raise a question, however, as to whether the interest charge proposal provides a benefit that is comparable to the existing DISC provisions and whether the $2,500,000 of export receipts cut-off for small exporters is not too low a figure.

Transition Rules

There will be a need for transition rules for companies terminating a present DISC and moving to an FSC operation. It would be desirable for example, to deem existing DISC long term sales contract arrangements as qualifying under the new rules. Similarly, the fact that DISC's have various mixes of qualified assets during the year should be considered in connection with the winding up of DISC operations, perhaps requiring compliance only with the gross receipts test as of the date of termination, rather than having to meet the asset tests on a specific date.

The legislation should also provide for tax free transfers of marketing and other appropriate assets from a U.S. DISC to a foreign sales corporation.

Alternatives to Selling Activity

The present proposal for a FSC substitute has sought to transfer a number of concepts of the present DISC to foreign corporations while avoiding some of the complexities and difficulties of the existing DISC legislation, such as the export asset tests and incremental base period income rules. These represent a very positive simplification. On the other hand, the concentration upon the GATT understanding and panel reports, which were concerned with foreign selling activities, may overlook useful and significant alternatives to solely requiring increased foreign-based selling activities.

One such matter is the financing of U.S. export receivables. Under present law, a qualified activity of a DISC is the purchase from a related supplier of receivables arising on the export of U.S. property and the DISC is entitled to tax benefits on a portion of the income it realizes in performing this financing function. Indeed, in some cases, this has become a very significant export role for a DISC in a company organization. In contrast, the proposed legislation would eliminate any favorable tax treatment for the financing of U.S. export receivables. It appears improbable that an off-shore export receivable financing affiliate would violate existing GATT provisions and such activity was certainly not raised in the GATT panel reports during the DISC controversy. Financing is a major element in an export program and further consideration should be given to this subject. Similarly, the holding and licensing of sales franchises and intangible rights by off-shore affiliates might offer an additional offshore alternative that would not raise factual problems as to the location of selling activities or questions as to whether a foreign entity was doing what it purported to do. The relatively bright line tests that could be written for such economic activities could be of considerable significance for smaller exporters.

Future Review of Export Rules

The present revenue constraints have precluded a broader examination of export tax policy concerning not only goods and commodities but services as well. In addition, the rules concerning taxation of service income under the GATT and related Subsidies Code involve somewhat different distinctions. The existing DISC rules and the FSC substitute cover only limited aspects of service exports. The U.S. has been attempting for some time to put together a comprehensive export policy, as evidenced in the recent Export Trading Company legislation. These efforts are still fragmented, however, as demonstrated by the fact that tax rules were effectively declared out of order during consideration of the Export Trading Company. The U.S. should not lose sight of the need for a comprehensive policy as a national priority.

The U.S. trade representatives perceive a strong need for the U.S. to accommodate its present export tax rules to the concerns of our trading partners. Such a step would be a significant indication of U.S. willingness to support international trade rules. The FSC proposal would provide U.S. exporters with the maximum tax advantages that could be available to foreign competition under the present trade rules. U.S. exporters should be able to compete on a comparable basis. Whether the present international rules make sense as both tax and trade policies is a further question. The U.S. should seek to encourage further examination and harmonization of both tax and trade rules as they apply to the full spectrum of exports of manufactured goods, commodities and services.

Statement of
Rochester Tax Council
Before the Committee on Finance
Hearings on S.1804 -
Foreign Sales Corporation Act of 1983
Friday, November 18, 1983

In lieu of oral testimony, the Rochester Tax Council appreciates this opportunity to submit a brief written statement of its position and comments with regard to S.1804, the Foreign Sales Corporation Act of 1983. The Rochester Tax Council is an organization of major companies that have strong affiliations with the Rochester, New York area. The Council has regularly taken an active interest in corporation tax policy issues, particularly those relating to international business. The Council's members are:

Bausch & Lomb, Inc.
Champion Products
Gannett Co., Inc.
Garlock, Inc.
Gleason Works Company
Eastman Kodak Company
The R. T. French Company
Schlegel Corporation
Security New York State Corporation

Sybron Corporation

Xerox Corporation

Members of the Rochester Tax Council are strong supporters of free and open international trade and consequently support the General Agreement on Tariffs and trade (GATT). Consistent with this support of foreign trade, we took an active role in the enactment of the Domestic International Sales Corporation (DISC) legislation in 1971 and have continued to endorse and support DISC legislation. We believe that exports of American goods have been encouraged by this legislation in a way that balances exporting incentives of other countries and generally promotes free trade. Consequently, we believe that the position taken by GATT with respect to the United States DISC legislation is unfair and inappropriate. Nevertheless, we are prepared to accept the reality of the GATT decision and the United States' commitment to propose a legislative alternative to DISC.

Any alternative to DISC should be premised on the fact that the DISC legislation has provided a practical and simple mechanism to encourage exports of American products. In our statement to this committee on April 20, 1976, we reported the results of a statistical analysis made by members of the Rochester Tax Council for the period 1971 through 1975. The results of this study, based on the reports of the industrial corporations included in our Council, showed that exports had increased from $549.7 million to $1,085 billion, an increase of more than 97 percent. As of 1972 approximately 19,400, or 12 percent of the approximately 161,300 individuals employed by industrial members of the Council were engaged in manufacturing or sales jobs which were sustained by export sales of these member corporations. In 1975 approximately 26,100, or 14.5 percent of the approximately 180,100 individuals employed by industrial members were engaged in manufacturing or sales jobs sustained by reason of export sales. Thus, between 1972 and 1975 export related jobs in the Rochester area increased by more than 34 percent. This dramatic increase in the number of employees engaged in export related jobs resulted from a large increase in export sales as opposed to domestic sales during the period. During this period export sales increase by 69 percent, whereas domestic sales increased by 36 percent only. While we have not completed our new study to update this information, the information from one of our larger members concludes that in 1982 28 percent of its United States employment is sustained by export sales. As noted above in 1975, Council members generally had 14.5 percent of its employees in export related jobs. Thus, we believe that the efficacy of the DISC legislation in promoting exports has continued to be dramatically illustrated by the actual experience of the members of the Council. Therefore, based on our own practical experience as well as the broader studies that have been completed by others, we believe that goals of the present DISC legislation must be continued by some means that is both practical and cost efficient.

We support S.1804 because we believe that it can accomplish the goals that are presently being accomplished by the existing DISC legislation. Our representative has worked for many months as part of the business group that has met frequently with the Office of the United States Trade Representative and the Treasury Department. These meetings have been most constructive and we wish to express our appreciation to the Office of the United States Trade Representative and the Treasury Department for the constructive responses that they have given to suggestions from this business group. We believe that this exchange of views has accomplished much which is reflected in S.1804 in developing a proposal that is not only intended to continue the policy goals of existing DISC legislation but is also intended to do so through a means that is both practical and cost efficient.

There are, however, some important points that need to be clarified before we can feel comfortable that the Foreign Sales Corporation (FSC) is a practical, cost efficient alternative to DISC. These issues include the following:

1. the Office of the United States Trade Representative and the Treasury Department in meetings with the *ad hoc* business group have developed a draft working paper which clarifies the foreign presence requirements under proposed sections 924 and 925. This draft, after appropriate refinement, should be included in the legislative history of S.1804.

2. S.1804, and in particular the background material developed by the Treasury Department and the Office of the United States Trade Representative, are almost exclusively based on the assumption of an FSC that will buy export products from a related supplier and then resell these products. However, most DISCs operate as commission agents for related suppliers and it is broadly anticipated that most FSCs will also operate as commission agents. Consequently, we consider it quite important that your staffs, in association with the Treasury Department and interested business groups, reevaluate the provisions of S.1804 in general, and section 924(e) in particular, to confirm the need for, and the efficacy of, the requirements of section 924(e) in the case of a commission FSC.
3. Most of the attention in the development of S.1804 seems to have been either on very large multinationals or small businesses that qualify for the small FSC definition of section 922(b). More attention needs to be given to problems of medium size companies such as several of the members of the Rochester Tax Council who do not qualify as small FSCs, but who cannot afford to employ additional persons in the Virgin Islands or other areas remote from their business operations to take on administrative burdens added by this legislation. This legislation should operate in a manner that will not impose new obstacles or significant costs on American companies exporting abroad.

4. While we take no position on the merits of the proposal, we believe that section 1(c) of the Act (dealing with treatment of certain trade receivables) is unrelated to this important legislation and can only complicate and obstruct this legislation. If it is deemed appropriate to make legislative changes with respect to the treatment of such trade receivables, it should be handled as separate legislation or as part of an omnibus tax bill.

In summary, subject to the specific points noted in the preceding paragraph, we endorse and support S.1804. We look forward to working with your staffs and in continuing to work with the Treasury Department and the United States Trade Representative in clarifying and improving this legislative proposal.

socma SYNTHETIC ORGANIC CHEMICAL MANUFACTURERS ASSOCIATION, INC.
1075 CENTRAL PARK AVENUE, SCARSDALE, N.Y. 10583 • (914) 725-1492

STATEMENT OF THE SYNTHETIC ORGANIC CHEMICAL MANUFACTURERS ASSOCIATION

SUBMITTED IN CONNECTION WITH THE
HEARINGS CONDUCTED BY THE
UNITED STATES SENATE
COMMITTEE ON FINANCE
ON NOVEMBER 18, 1983
REGARDING THE FOREIGN SALES
CORPORATION ACT OF 1983 (S. 1804)

December 9, 1983

WASHINGTON OFFICE 1612 K STREET, N.W., WASHINGTON, D.C. 20006 (202) 659-0060

STATEMENT OF THE SYNTHETIC ORGANIC CHEMICAL MANUFACTURERS ASSOCIATION REGARDING THE FOREIGN SALES CORPORATION ACT OF 1983 (S. 1804)

The Small Business Committee of the Synthetic Organic Chemical Manufacturers Association, Inc. (SOCMA) welcomes this opportunity to submit this statement in connection with the Committee's hearings on S. 1804, the Foreign Sales Corporation Act of 1983. SOCMA is a nonprofit association of producers of organic chemicals. A majority of its one hundred members are small companies with annual sales of less than forty million dollars. A list of SOCMA members is attached to this statement.

SOCMA commends the efforts of the Senate Finance Committee to develop legislation which will meet the objections of our GATT trading partners yet maintain the important export incentive that the DISC program has provided for American business. We feel that S. 1804 represents a significant step toward this goal, and, with only a few exceptions, we would urge the speedy enactment of its provisions.

Our primary reservation is that provisions of S. 1804 are not adequate to protect the interests of small businesses. To a large corporation with already substantial foreign contacts, the establishment of a Foreign Service Corporation (FSC) may not be particularly burdensome. However, the foreign presence and management requirements of S. 1804 (Section 924(d)) would prevent the vast majority of small business from availing themselves of the FSC tax benefits and thus discourage them from engaging in export sales. Clearly, this is a consequence that the American economy can ill afford.

S. 1804 has attempted to mitigate this problem by including some provisions which would enable certain small businesses to maintain the tax advantages they currently enjoy under the DISC system by establishing small FSCs (Section 922(b)), jointly owned FSCs, or interest charge DISCs (Section 995). While we endorse the objectives of these provisions, we are concerned that they will not be sufficient to meet the needs of most of SOCMA's small business members. We therefore recommend that S. 1804 be amended to make these and other options available to more small exporters.

Small FSCs

Under Section 924(b)(2), a FSC with $2.5 million or less in foreign trading gross receipts would be exempt from the most costly of the foreign management and economic process requirements and would be permitted to retain only a *de minimus* foreign presence. Such an FSC would still be required to maintain an office outside the United States, keep a summary of its permanent books at its foreign office, and have at least one director who resides outside the United States. However, its management, bank accounts, and major economic activities could remain in the United States.

We believe that this provision is essential to the continued success of America's small export firms. However, the $2.5 million limit will freeze out the majority of SOCMA's small to medium-sized member firms. These businesses typically generate enough gross receipts to disqualify them from the Small FSC exemption, yet their profits will not be large enough to allow them to meet the onorous requirements for establishing an ordinary FSC.

SOCMA therefore urges that the limit be raised to $5 million. We feel that this is a far more realistic figure, and we believe that it would significantly ease the burden on the American export industry. In addition, we would like to lend our support to the suggestion of the Chamber of Commerce of the United States that transitional limits of from $10 million down to $5 million be used over the next five years to allow firms time to comply with the new tax laws.

Jointly-Owned FSCs

S. 1804 would allow companies to reduce some of the costs of establishing their own FSCs by grouping together and organizing jointly-owned FSCs. We applaud this plan as a useful option for small businesses which would like to enter the export market but cannot afford the initial capital expenditures which setting up an independent FSC would entail. However, we would urge the Committee to insert an explanatory provision into the legislation, or to call for the promulgation of explanatory Treasury regulations, which would ensure that such joint ventures will be able to operate in a manner that will not require the disclosure to all shareholders of a participant's confidential business information such as product sales and profit on such sales.

Interest Charge DISCs

Section 2 of S. 1804 would permit small businesses with less than $10 million in export gross receipts to maintain their current DISCs, but would require them to pay interest at the Treasury bill rate on the tax deferred. SOCMA does not view this as a viable alternative to the DISC program now in effect. The medium sized firms with DISCs which might benefit from such an option are disqualified by the $10 million limit, while the smaller firms which qualify are the least able to afford the extra interest cost. The only benefit this alternative would provide to these small businesses is the difference between the Treasury bill rate interest charge and the present cost of borrowing money, a benefit substantially less attractive than the current DISC rules or the proposed FSC rules.

SOCMA therefore recommends that the qualifying limit for this option be raised from $10 million to $25 million for a five year transition period to enable more firms with existing DISCs to take advantage of it while they form FSCs. In addition, we suggest that S. 1804 be amended to provide an alternative DISC-type mechanism for the smallest exporters. This provision should enable a company with $164,000 or less in taxable export income (the small business definition in § 995(f) of the Internal Revenue Code updated for inflation since January 1, 1976) to maintain a DISC in the United States without paying interest on the deferred taxes if it meets the following minimum requirements:

1. It retains one or more foreign agents who maintain offices outside the United States to represent it in foreign countries;
2. It grants such agent(s) an exclusive or nonexclusive agency agreement, franchise agreement, or distribution license with respect to the product sold; and
3. It engages in foreign economic processes by having its foreign agent(s) perform at least three of the following activities:
   (a) solicit orders from and negotiate sales contracts with customers;
   (b) process customer orders;
   (c) bill customers and receive payment;
   (d) engage in advertising and promotion activities; or
   (e) assume credit risk, risk of loss from casualty, damage, etc. or foreign exchange loss.

A DISC meeting the above criteria would be deemed to be earning income from economic activity outside the United States, as required by the GATT. The amount of income subject to tax exemption would be computed in the same manner as for foreign-based FSCs. We feel that this proposition strikes a reasonable balance between conciliating the members of the GATT Council and ensuring that our smallest exporters are not placed at an unfair competitive disadvantage in the world market.

Conclusion

SOCMA supports the attempt made in S. 1804 to deal with the problems faced by small businesses in establishing and maintaining overseas operations in order to qualify for the FSC tax benefits. However, we feel that the small business provisions, though aimed in the right direction, do not go far enough. We urge the Committee to give serious consideration to the recommendations we have presented so that a greater number of small American businesses may profitably engage in the international export trade.

Union Planters
National Bank

STATEMENT

by the

UNION PLANTERS NATIONAL BANK OF MEMPHIS
67 Madison Avenue
Memphis, TN 38103

to be included in the record of the hearing held

by the

COMMITTEE ON FINANCE
UNITED STATES SENATE

on

Friday, November 18, 1983
SD-219 Dirksen Senate
Office Building

regarding

S.1804, THE FOREIGN SALES CORPORATION ACT OF 1983

P.O. Box 387 • Memphis, TN 38147

Union Planters National Bank of Memphis became involved with export tax incentives a number of years ago when a group of our farm customers asked us to help them set up and service their cooperative's Domestic International Sales Corporation (DISC). Since that time, we have used this experience to develop a service designed to help exporters, particularly those in agribusiness, operate their own DISC's. We are therefore interested in seeing that the Foreign Sales Corporation (FSC) becomes a workable replacement for DISC.

In constructing a viable tax incentive that is also acceptable to our GATT partners, we would urge the committee to be sure that the FSC is workable from the point of view of the exporter. The bill must require enough foreign activity to appease GATT, but it must also be flexible, rather than restrictive, so as to allow the exporter to decide how to qualify for the tax benefits rather than whether or not he will participate at all. The present bill goes a long way toward achieving these ends, but it would seem to require certain clarifications and alterations in order to make it more attractive to exporters.

A key element of the flexibility needed in the law must come from the exporter's ability to contract out all requisite activities. It appears that this has always been the intention of those who put together the legislation. However, the wording of the bill itself, while mentioning the contracting of services in a number of places, is somewhat more vague than the preceding literature on the FSC proposal. We would like to see the bill's wording strengthened so that it clearly permits all activities to be performed for the exporter on a contract basis.

In addition, the general and technical explanations which came out last June clearly outlined which activities had to be done outside the U.S., and expressly stated that the remaining activities could be performed inside the U.S. Regretably, the bill is somewhat less explicit. We want to be sure that those activities not done offshore to meet the minimum foreign presence requirements can be done inside the United States. This clarification could best be made by inserting wording into Section 925(c) so that it reads: "A sale by an FSC meets the requirements of this subsection if--. . . (all the stated activities) have been performed inside or outside the United States by such FSC (or by any other person acting under a contract with such FSC)." Such wording is consistent with the technical interpretation of the FSC proposal which came out last spring.

Most importantly, however, we would like considerable clarification with regard to the required foreign economic activities, Section 924(d) and (e). We recognize the need for certain ambiguities in the wording of the legislation when dealing with factual events. But in order to plan for operations within an FSC, exporters need some additional guidelines than currently exist in the proposal. A combination of refinements in the bill and examples of acceptable activities in the legislative history would prove extremely helpful.

In general, although the bill defines both foreign and total direct costs, it does not describe how to allocate costs between locations. It would seem both practical and acceptable for the expenses arising from activities referred to in Subsection (e) to be paid for by the foreign director out of the FSC's foreign bank account. The costs could therefore be deemed to have been incurred offshore. If such a scenario were acceptable, it would both ensure the active participation of the foreign office on a transaction-by-transaction basis and be of minimal disruption to the exporter.

We would also like to see more detailed definitions of certain terms used in Subsections (d) and (e). Specifically, we would like to see a clear differentiation between solicitation (Section 914(d)(1)(A)) and sales promotion (Section 924(e)(1)). Even after several readings there does not appear to be a clear difference between the meanings of the two terms. Likewise, the transportation requirement (Section 924(e)(3)) would appear to overlap the requirement for arranging delivery (Section 924(e)(2)).

Subsection (e) seems to require certain other adjustments in order to make the FSC a more workable incentive. Most importantly, the requirement that payments be received outside the U.S. seems to be impractical and perhaps even counterproductive. In our consulations we have seen that many exporters are reluctant to have payments received in this way. When fully analyzed, the reasons for this reluctance seem clear. To begin with, we assume that although payment must be received offshore, se funds may be repatriated for use in a parent company. ever, such international funds transfers have important side ects. Use of that money is lost for the time it takes to effect the transfer. Normally, a day will be lost for each bank the money passes through. Over a series of transactions, such transfers would undoubtedly lead to considerable loss of time and this could represent a rather substantial hidden cost. Of course, efficiency could be gained by maintaining the FSC's bank accounts at foreign branches of domestic banks. This, in turn, could result in a substantial windfall for the large money center banks which could offer accounts almost literally around the world (thus simplying the transfer procedure as intrabank transfers can be effected much more quickly). Surely, the realignment of account relationships is not a goal of the legislation, but that could very well be the effect at least for those exporters seeking to minimize their substantial loss use of funds.

Looking still deeper, we would point out that a large portion of international payments are made under letters of credit. It is both commonplace and conducive to have the beneficiary of a letter of credit and the advising (paying) bank in the same country. However, the bill's foreign payment requirement would seem to require a change in this practice. Either U.S. banks would have to transfer funds to foreign bank accounts (essentially doubling that inefficiency) or U.S. export letters of credit would have to be negotiated by foreign banks. Neither of these options is particularly palatable.

It seems, then, that the requirement that payments be received outside the U.S. would have some adverse effects which apparently were not foreseen when the legislation was put together. It could have a sweeping effect on banking relationships with the large money center banks appearing to be the big winners. It could also have a disruptive impact on letter of credit transactions. But, more to the point, the hidden costs associated with the necessity of transferring funds into and out of the country could greatly reduce the ability of American firms to compete in the world markets while holding the line on costs can often make the difference between making a sale and losing it. It does not stretch the imagination too much, then, to see that the effect of this requirement could be entirely counterproductive. It could end up inhibiting rather than encouraging U.S. export sales.

We would, therefore, favor significant modification of this requirement. Specifically, we feel that it is crucial that the legislation allow for the deposit of payments into a domestic account of the FSC. All associated fees and expenses (negotiation fees, confirmation fees, etc.) could be disbursed from the FSC's foreign account. All this could be achieved by changing the requirement in Section 924(e)(4) to read: "the determination and transmittal of a final invoice or statement of account _or_ the receipt of payment."

The assumption of credit risk requirement also needs further examination. Although the bill includes no explanation, we assume the requirement will be interpreted along the lines set out in the technical explanation which came out last June. However, the technical explanation judges credit risk on the basis of bad debt experience. Obviously, new corporations have no bad debt experience and new FSC's will therefore be unable to demonstrate compliance with this requirement. It is also conceivable that an existing corporation might not have bad debt experience. One resolution to this problem would be to deem that an FSC is in compliance with this requirement until a bad debt situation arises. As an alternative, an FSC could be asked to set up a bad debt reserve offshore, but this would result in a needless additional cost to the FSC.

The credit risk issue points up an even larger question of how the guidelines are to be applied in the absence of one of the cost categories. For instance, many companies doing business in the international market do not advertise in the conventional sense of the word. Again, deemed compliance would seem to be in order.

As a final practical aid to the exporter seeking to take advantage of the FSC's tax benefits, examples (preferably in the legislative history) of how the rules are to be applied would help him plan the operational structure of his new subsidiary. The technical explanation referred to earlier included suggested definitions and application of terms. Examples, particularly some addressing the issues discussed above, would allow the exporter to set up his FSC with reasonable confidence in its compliance, and would therefore be a welcome addition to the bill's legislative history.

In summary, the bill now before the committee outlines a proposal which could go a long way toward both appeasing our GATT partners and creating a viable tax incentive for exporters. However, we cannot overemphasize the need to make the program a practical option for the exporter; no other alternative will achieve the desired ends.

Respectfully submitted,
UNION PLANTERS NATIONAL BANK

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